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ABSTRACT

This guide for members of the governing boards of independent colleges and universities is intended to provide information necessary to an understanding of college and university financial statements, especially annual financial statements. Following an introductory chapter, chapter 2 identifies key questions and strategic issues facing institutions in the areas of pricing, financial aid, revenue sources, costs, physical plant/capital maintenance, and measures of service efforts and accomplishments. Chapter 3 offers an overview of the requirements of the financial reporting process, including definitions, the statement of financial position, statement of activities, statement of cash flows, the financial reporting process, and objectives of financial reporting. The next three chapters examine the statements of financial position, activities, and cash flows in more detail. Chapter 7 addresses external market assessments such those from Moody's Investors Service and the Standard & Poor's evaluations of operating ratios, financial strength ratios, and liquidity and cash flow ratios. Chapter 8 offers guidelines for effective internal assessment of financial health, and covers tuition dependance, financial aid, endowments, costs, and use of debt. Examples using a hypothetical university are provided throughout the guide and in two appendices. (Contains 12 references.) (DB)

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A Strategic Guide for Independent College & University Boards

Understanding Financial Statements

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By John H. McCarthy & Robert M. Turner
with Sandra L. Johnson, editor

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Association of Governing Boards
of Universities and Colleges

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1
INTRODUCTION

As college and university trustees wrestle with the challenges their institutions face, they need reliable financial information to help them make sound decisions. One important source of such information is the institution's annual audited financial statements and the notes that accompany them. Although reading and understanding these documents can be daunting, trustees should know the basic contents of these annual financial statements and how to interpret them.

After years of analysis and debate, the Financial Accounting Standards Board (FASB) issued new standards that affect the way private colleges and universities present their financial information. The FASB was established in 1973 as the accounting standard-setting body for corporations and nonprofit organizations, including colleges and universities. Most institutions had to comply with these standards beginning in fiscal 1996. These changes in financial reporting represent the most comprehensive revision in the history of financial reporting by nonprofit organizations. The revision required board members and anyone else who needed or wanted to understand the financial condition of the institution to reeducate themselves on both the form and content of the financial statements.

The primary consequence of the revision is that financial statements for nonprofits are more similar in form to those found in the for-profit sector. However, the FASB allowed for a degree of flexibility in the way institutions present their financial results, especially in the statement of activities. This flexibility was meant to allow various groups, such as college and universities, to develop statements in formats their constituents found most useful. Even before the FASB standards took effect, colleges and universities developed many variations of the basic financial-statement presentations. Eventually, associations serving colleges and universities may develop guidelines that will provide more structure to these reports, and perhaps they will be more similar from one institution to another.

Before we begin to explore college and university financial statements in depth, an understanding of the concept of financial reporting is necessary. Although financial statements are part of the overall package, financial reporting is broader. The FASB has stated that general purpose external financial reporting should focus on "providing information to meet the common interests of external users who generally cannot prescribe the information they want from an organization."[1] Financial reporting includes not only the financial statements but also supplemental information that sheds light on the financial statements themselves. Such supplemental data may include disclosures on students, faculty, enrollments, level of experience and quality of management, and measures of service efforts and accomplishments. According to one recent study, users of college and university financial information want such data.[2] Service efforts and accomplishments are

[1] FASB Concept Statement No. 4, "Objectives of Financial Reporting by Nonbusiness Organizations," 1980, par. 10.
[2] Robert M. Turner, "An Examination of External Financial Reporting by Colleges and Universities," Doctoral Dissertation for the Boston University Graduate School of Management, 1992, page 132.

measures that colleges and universities will develop themselves over time in an effort to capture the effectiveness and efficiency with which institutions carry out their academic mission.

Those who use college and university financial data—such as accrediting boards, rating agencies, financing sources, potential donors, and even prospective students—say they believe supplemental data enhance the financial information an institution's financial statements provides. For example, enrollments have a significant influence on the ability of the institution to generate revenues to meet debt and other financial requirements.

Board members are both internal and external users of financial information. They have a fiduciary responsibility to ensure the institution uses its resources in a responsible way and to monitor its financial health. At the same time, trustees participate in internal decision making regarding budgets, changes in programs, and decisions affecting revenues and expenses. As board members, they are accountable to such external users of financial reports as financial markets, accrediting agencies, and others to whom the financial reports are directed.

Board members also are responsible for helping their institutions create reports that meet internal and external needs for sound information. Financial information is meant to *assist* in decision making—*it is not the decision*. Consequently, reports should be developed in such a way that the board can use them to meet various decision-making objectives it believes will help it carry out the institution's mission.

College and university financial statements can be difficult to read and interpret. At a basic level, they describe the institution's assets and liabilities, operating results, and cash flows. More broadly, they are designed to present a picture of the institution's financial health and tell how its resources have been used over the course of a year. Financial statements are an important assessment tool not only for the institution and its trustees but also for such external constituencies as donors, rating agencies, banks, regulators, parents, and prospective students. In short, financial statements tell an important story, and boards need to ensure their institution's financial statements tell that story well to relevant external users.

In the last thirty years, understanding the financial portrait of an individual institution has become increasingly important. In the 1950s and 1960s, higher education as an industry grew rapidly. According to former Harvard University President Derek Bok, as "society came to rely more and more on universities, the universities in turn grew even more dependent on society for the money required to support their expanding activity."[3] In the ensuing years, higher costs of operation and societal demands for accountability increased the pressure on colleges and universities to manage their facilities effectively. Still, the public looked to higher education institutions to provide solutions to society's problems. The result was a "vast network of relationships" linking the university to other institutions in society.[4] No longer was the college or university the "Ivory Tower" it had been in the past.

Against this backdrop, it was inevitable that colleges and universities would have to find ways to disseminate a clearer picture of financial information to those who provided their resources. In fact, in defining the objectives of financial reports, the FASB wanted board members and others interested in the financial performance of their institution to develop measures of service efforts and accomplishments that would help them understand the effectiveness and efficiency with which the institution used its resources. Consequently, financial statements for nonprofit organizations, including colleges and universities, focus on expenses displayed by program areas so that board members and others can understand the costs of these programs and assess their effectiveness and efficiency.

[3] Derek Bok, *Beyond the Ivory Tower*, Cambridge, Mass.: Harvard University Press, 1982, page 7.
[4] Ibid., page 7.

Some individual trustees have deeper financial expertise and understanding of financial statements than others. Some likely will be recruited because of their financial expertise to serve on the finance or audit committee. The responsibility of these trustees is to share their understanding of financial and audit matters with other members of the board.

It is the objective of this book to help all trustees gain a better understanding of college and university financial statements. Although the book focuses on annual financial statements, trustees will want to review other types of financial reports to monitor the financial health of their institutions. In general, these reports should be prepared concisely and in an easy-to-understand format. A good overview of some of these reports as well as the general financial responsibilities of board members can be found in *Financial Responsibilities of Governing Boards*, published by AGB and the National Association of College and University Business Officers.

Financial information is critical in making informed decisions, and timely information will allow boards to have the financial flexibility to deal with changes that affect their institutions. We hope all trustees will benefit from the discussion and analysis that follows so they can use financial information to make better decisions. Financial statements are not simply dry, complex columns of numbers. Rather, they are an important vehicle for communicating the institution's financial story. Trustees, who ultimately are responsible for the financial health of their institutions, also are responsible for understanding the story the financial statements tell and interpreting it for the community. We believe this book will help trustees accomplish these goals.

2

KEY QUESTIONS AND STRATEGIC ISSUES FACING INSTITUTIONS

As colleges and universities have grown over the last few decades—both in numbers of students and in the size of their physical plants—they have turned to various sources of revenue other than tuition to provide financial resources. Institutions rely on financial markets, donors, alumni, and foundations as well as the federal and state governments to meet their rising costs. In return, those who provide additional resources demand more accountability because colleges and universities represent only one of many kinds of organizations competing for supplementary funds.

This accountability may take the form of reports to the U.S. Department of Education on student loans, to other funding sources in the form of audited financial statements, or to magazines and guidebooks that purport to rate colleges and universities. The FASB, too, has responded with new financial-reporting requirements that took effect beginning in fiscal 1996. Over time, these requirements may lead colleges and universities and other nonprofit organizations to adopt more uniform financial reports. The goal is to allow those who read and use these documents—from board members to campus administrators to individuals and organizations that provide additional financial funds—to better assess the effectiveness and efficiency with which institutions use their resources.

Boards should keep in mind that the major objective of financial reports is to provide information for decision making in support of the institution's mission. Sometimes, when management techniques are applied to the nonprofit sector, there is a fear that an organization's mission will become secondary to these management techniques. However, this should never be the case. Financial reports should help boards address key issues, answer salient questions, and help them develop creative approaches to the challenges their institutions face.

In the following chapters, we will discuss college and university financial statements in detail, and we will examine various ratios that boards can use to analyze the financial health of their institutions. We will then discuss how board members can use financial information to address key issues and questions. But before we discuss how boards can use financial reports as information for decision making, it may be helpful to address some of the key issues facing colleges and universities.

While colleges and universities differ in mission, focus, and their emphasis on research, teaching, and service, many issues affect all institutions. In addressing such issues, board members must be aware of their financial implications, including the effect they may have on the long-term viability of the institution's programs and on the institution itself. Boards should insist that financial reports address the key questions and strategic issues the institution faces and that the reports allow board members to plan and react to changes.

While no list of issues affecting colleges and universities can be comprehensive, most institutions face those highlighted in this chapter. Board members and senior administrators should add to this list the critical issues that face their institution and use this combined list to help frame the type of financial information they need to help them make decisions.

PRICING

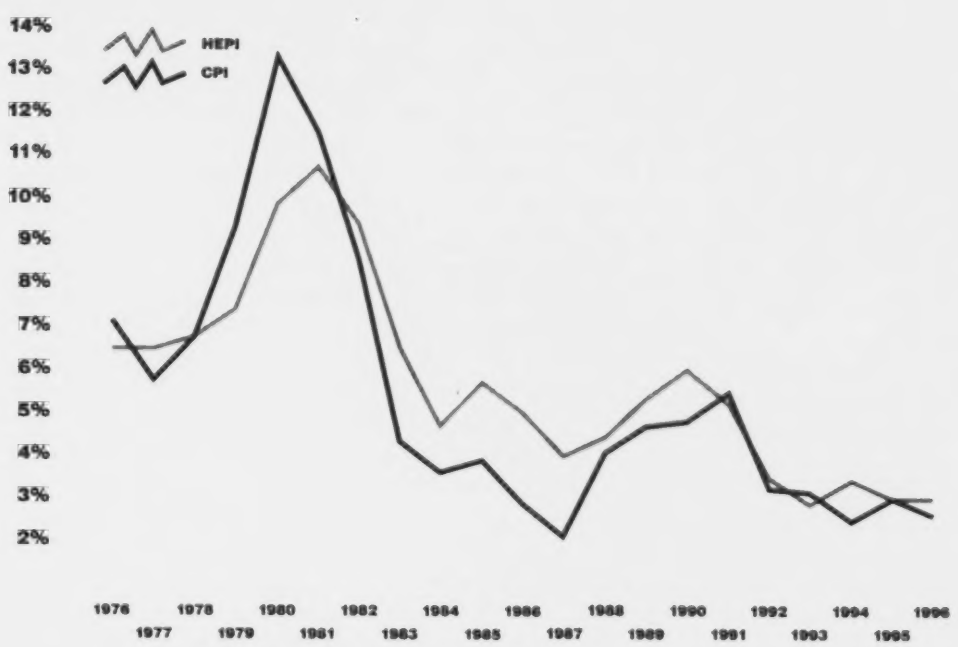
Cost no longer is a factor only at private institutions, as tuition and fees have continued to increase faster than inflation in the public sector as well. Consequently, more students and their families are finding it a greater challenge to afford the cost of higher education.

Two factors are at work: pricing and financial aid. From a pricing perspective, institutions have become more conscious of keeping tuition increases in line with the rate of inflation, but the "basket of goods" purchased by these institutions often does not reflect the Consumer Price Index. In fact, a separate index was created, called the Higher Education Price Index (HEPI), to measure price changes in more than 100 goods and services colleges and universities purchase. Not so long ago, institutions would add up their costs for the coming academic year and determine the needed tuition charge based on these costs. Now it has become common practice for institutions to select a reasonable tuition increase and try to make their costs fit this increase (see Table II-1).

A board should develop a long-term strategy to control what it charges for tuition and fees. An institution charging $15,000 in tuition today could see this number grow in ten years to $24,000 with an annual increase of 5 percent or to $39,000 with a yearly increase of 10 percent. Will students be able to afford $24,000? Would $39,000 drive away a major portion of the applicant pool? Clearly, controlling tuition increases has major long-range implications for an institution's ability to meet its enrollment targets. Tuition policies must be evaluated in light of such other sources of revenue as research, gifts, investment income, and the trend information on them.

TABLE II-1

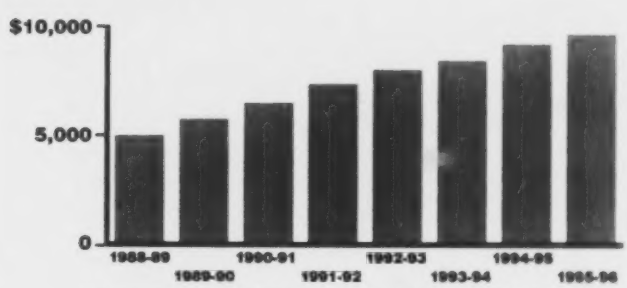
COMPARISON OF THE HEPI AND THE CPI: 1976-1996*



*As reported by Research Associates of Washington in *Inflation Measures for Schools, Colleges & Libraries* (1996 Update)

TABLE II-2

GROWTH OF INSTITUTIONALLY (AND OTHER) FUNDED AID*



*As reported by the College Board in *Trends in Student Aid: 1986 to 1996*. In constant 1995 dollars (in millions).

FINANCIAL AID

One of the most challenging issues facing private colleges and universities (and more recently, public institutions) is financial aid for students. As federal and state sources of financial aid have failed to keep pace with the rising costs of college, institutions have had to provide their own funds to meet the shortfalls. In effect, the institution's financial aid becomes a tuition "discount" for students. The financial markets also see tuition discounting as an important issue in assessing both operating results and cash flows.

Boards grapple annually with financial-aid policies. Often their primary concern is the ability of their institution to meet its enrollment expectations. This is one reason more institutions are adopting an enrollment-management perspective that combines admissions, financial aid, and the registrar functions under a single dean or director. Such an organizational structure can help manage enrollment and the associated revenue streams.

Many institutions find themselves competing with other institutions for students on the basis of price. Astute students and their families are asking colleges to adjust their aid packages to meet those of competing institutions. Since overall costs at many four-year private institutions have surpassed the $100,000 mark, this practice is likely to persist. Colleges and universities must continue to develop more sophisticated models for awarding aid, but all must come to terms with the level of discounting their institution can sustain. (A good source of information on tuition pricing and student aid is the Spring 1997 issue of AGB's *Priorities*, "The New Equation on Tuition and Aid," by Arthur M. Hauptman.)

Table II-2 presents data from the College Board. It shows the level of institutionally and other funded student aid almost doubled from 1988–89 through 1995–96.

REVENUE SOURCES

Board members and the financial markets are concerned with the various components of an institution's revenue. In today's environment, all institutional revenue sources are constrained, and many institutions rely heavily on a single revenue source—tuition. Other sources include research funds, government grants, alumni and donor gifts, and endowment income.

However, understanding the various revenue components, and the institution's reliance on each one, allows a board to respond to changes in the external environment and to assess the impact on operations and capital needs.

Historical trend information and projections of future revenue streams under different scenarios can help board members make the necessary decisions if a shortfall occurs in one source of revenue or another.

COSTS

Just as the board and financial markets are concerned with sources of revenues and trend information about them, so too must the board have trend information on costs and the long-term implications of the growth rates of various costs. This is closely related to the issue of "expensive policies," a topic we'll soon discuss.

Colleges and universities incur some costs over which they have little control (such as library books) and other costs over which they have greater control (certain salaries). Costs also can be analyzed from the standpoint of program costs, such as those for instruction, or natural cost categories, such as salaries and fringe benefits. Another perspective is administrative costs versus academic costs. Presenting costs in the manner most useful to a particular institution and situation gives board members the ability to react to both short-term and long-term changes in their planning models and to weigh alternatives when cost cutting becomes critical.

Many institutions are rethinking how they can better control overall costs by reengineering certain areas (starting with administrative departments and eventually moving to the academic side of the house), developing consortia with partner institutions to improve their collective purchasing power, and outsourcing such functions as food service and bookstores. Employing such measures not only can reduce costs but also can improve service. Board members and senior administrators should weigh the costs and benefits of these approaches before embarking on a new cost-control program.

EXPENSIVE POLICIES

William S. Reed, vice president for finance and administration of Wellesley College in Massachusetts, has defined what he calls the "expensive policies" of an institution. In his annual report to the board, he describes such policies and the way they drive certain institutional costs. The report gives board members a context in which to understand the cost structure of the institution and how its mission and policies have supported certain costs. It also provides the board with information useful for long-range planning.

Board members at every institution should have this kind of information available to them before they approve annual budgets but also as a means of creating long-term projections. For example, a board might approve a costly financial-aid policy to attract a more diverse student body in a given year. Such a policy, however, must last for at least four years so students can complete their education. And what about succeeding years? Will the institution keep the financial-aid policy in place for other students?

Unless board members and senior administrators understand an institution's revenue and cost trends, they may misperceive the long-range implications of maintaining the status quo or adding additional costs. Any change in costs also should be projected over at least a ten-year planning horizon to see the implications of the cost's growth. Board members and senior administrators also need to understand which institutional costs are fixed over a period of time or level of activity and which costs are variable. Knowing this allows them to react to changes in assumptions underlying the budget model—for example, if the institution was underenrolled in a given year. Having this information available and understanding the costs and benefits of "expensive policies" allows boards and senior administrators to plan properly and to react to changing circumstances. Again, the mission and goals of the institution should remain central to the decision-making process.

PHYSICAL PLANT/ CAPITAL MAINTENANCE

Maintaining a campus's physical plant is a major challenge for most colleges and universities. Many buildings are historic; others were built for short-term needs. Colleges and universities routinely have deferred needed maintenance to shore up faculty salaries or meet other rising costs. Devising a plan for the annual upkeep of an institution's physical plant is a critical component of long-term financial planning the board needs to address. The condition of an institution's buildings can affect enrollment. It can affect the quality of education and even the health and safety of students, faculty, and staff. It also is one factor the financial markets evaluate when determining the long-term viability of an institution.

OTHER RISKS

Identifying and controlling the risks an institution faces is an important part of the planning process. Boards and senior administrators should quantify risks to fully understand their implications for the institution. How do these risks relate to financial reporting? Many of these risks must be reflected in various financial reports. Risks might include the following:

- ***Institutional financial aid.*** What percentage of the institutional aid budget is unfunded? Has this percentage increased over time? What are the long-term implications of continued increases in unfunded aid?
- ***Capital fund needs.*** What capital requirements is the institution facing, and what is its ability to raise the needed capital? Has the institution been deferring maintenance on its physical plant? Can the institution quantify its deferred-maintenance costs? What effect do these costs have on the calculation of capital fund needs? Do gifts for new buildings include funds for operating costs, or will these buildings require funds from the operating budget?
- ***Selectivity of the institution.*** How selective is the institution in accepting first-year students? What percentage of accepted students actually enroll? What percentage complete their education? How many years does this usually take? Is the institution able to retain most of its entering classes?
- ***Competition for faculty.*** Is the institution able to attract and keep top-quality faculty? How do faculty in the recruitment process view the institution?
- ***Regional, national, and global economic performance.*** In the region from which the institution draws its primary enrollment, what is the ability of students and their families to pay tuition and other costs? What effect might the national or global economy have on investment risks and returns? How might economic conditions influence fund-raising?
- ***Endowment management.*** To what extent is an institution reliant on endowment or investment income? What risks is it willing to take to increase its return? Is it taking on an acceptable level of risk given the size of its endowment or investment portfolio? Has the institution evaluated (or reevaluated) its exposure to derivatives or other risky investment strategies?
- ***Intergenerational equity.*** In their deliberations about revenues and costs, are board members considering how much should be preserved for future generations of students and how much should fairly and realistically be spent for today's students? For example, institutions deferring building maintenance may be requiring future generations of students to pay for building renovation, which by then may be extensive.
- ***Research funding.*** To what degree does an institution rely on federal research funding? What about other sources of research funding? What if these funding sources decreased?

- ***Regulatory compliance.*** Is the institution in compliance with Department of Education rules and regulations? Those of the NCAA? Those of the IRS and other federal agencies?

MEASURES OF SERVICE EFFORTS AND ACCOMPLISHMENTS

The FASB initiated a project several years ago to identify measures of service efforts and accomplishments that capture the effectiveness and efficiency with which a particular institution carries out its educational mission. Among the goals are to allow for more comparability among higher education institutions and to seek ways to quantify the value of a college education. Also behind this push are magazine and guidebook rankings, the concerns of parents and employers about the preparation of new college graduates for work, and the demands of government officials in some states to tie appropriations to institutional performance measures.

Boards and senior administrators must have input into this process rather than have the process thrust on them by outside parties. Some institutions are experimenting with outcome measures in an effort to justify increased future support. As institutions compete for limited external resources, they will have to justify their needs through measures of efficiency and effectiveness.

The level of financial, physical, and human capital available to each institution is limited. Defining, applying, and using financial reports and performance measures can help an institution focus on its mission. Financial reports and performance measures are not the end product. Rather, they provide decision-making information necessary to help further the institution's mission and goals.

3

OVERVIEW AND REQUIREMENTS OF THE FINANCIAL REPORTING PROCESS

Private colleges and universities fall under the jurisdiction of the Financial Accounting Standards Board. The Governmental Accounting Standards Board (GASB), established in 1984, has jurisdiction over public colleges and universities. Pronouncements issued by the FASB are the highest level of generally accepted accounting principles (GAAP). It is important to understand the standard-setting hierarchy because auditors rely on it to issue opinions on the financial statements they have audited. Only those financial statements prepared in accordance with GAAP can receive an unqualified opinion. Rating agencies, lenders, regulators, benefactors, and others often require an unqualified opinion before they can issue debt or give a university a grant.

The FASB developed a conceptual framework in the 1970s. It issued two concept statements directed at nonprofit organizations: Statement of Financial Accounting Concepts (SFAC) No. 4, "Objectives of Financial Reporting by Nonbusiness Organizations," and SFAC No. 6, "Elements of Financial Statements." These concept statements serve as the basis for all standards relating to nonprofit organizations issued by the FASB and therefore are important in understanding the financial-reporting model for colleges and universities.

SFAC No. 4, "Objectives of Financial Reporting by Nonbusiness Organizations," applies to external financial reporting by nonprofit organizations. The concept statement indicates that financial reporting should provide information to meet the common interests of external resource providers and other users. In brief, nonprofit organizations should present financial information that would be useful in the following ways:

- making rational decisions about the organization's allocation of resources,
- assessing the organization's services and its ability to continue to provide them,
- assessing how its managers have performed their stewardship functions,
- analyzing its economic resources and obligations, and
- evaluating its service efforts and accomplishments as performance indicators.

The focus, therefore, of external financial reporting is on *users* and the information they need to make decisions regarding the organization.

SFAC No. 6, "Elements of Financial Statements," defines seven elements of financial reporting by nonprofit organizations: assets, liabilities, net assets, revenues, expenses, gains, and losses (see Table III-1).

SFAC No. 6 also defines three categories of net assets for nonprofit organizations that are distinguished by the presence or absence of donor-imposed restrictions: (1) unrestricted net assets, (2) temporarily restricted net assets, and (3) permanently restricted net assets (see Table III-2). According to SFAC No. 6, "Elements of financial statements are the building blocks with which financial statements are constructed—the classes of items that financial statements comprise. *Elements* refers to broad classes, such as assets, liabilities, revenues, and expenses." (SFAC No. 6, par. 5)

TABLE III-1

DEFINITIONS OF THE SEVEN ELEMENTS OF FINANCIAL REPORTING

(italics added)

- *"**Assets** are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events."* (SFAC No. 6, par. 25)
- *"**Liabilities** are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events."* (SFAC No. 6, par. 35)
- "Equity or ***net assets*** is the residual interest in the assets of an entity that remains after deducting its liabilities." (SFAC No. 6, par. 49)
- *"**Revenues** are inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations."* (SFAC No. 6, par. 78)
- *"**Expenses** are outflows or other using up of assets or incurrences of liabilities (or a combination of both) from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations."* (SFAC. No. 6, par. 80)
- *"**Gains** are increases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity except those that result from revenues or investments by owners."* (SFAC No. 6, par. 82)
- *"**Losses** are decreases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity except those that result from expenses or distributions to owners."* (SFAC No. 6, par. 83)

The key distinction for these three classes of net assets is the control the institution has over their use. Permanently restricted and temporarily restricted net assets imply that the institution is bound by an outside resource provider—a donor, for example—who requires the institution to retain his or her gift indefinitely (in the case of permanently restricted net assets) or use the gift for a specific purpose (in the case of temporarily restricted net assets). In essence, permanently restricted net assets are true endowment. In the case of unrestricted net assets, the institution has full control over the use of the these assets. All activity involving revenues and expenses flows through unrestricted net assets. The separation of net assets into these three categories captures the financial flexibility of the institution in using these funds, an important indicator for the financial markets. Only unrestricted net assets are available for use at the institution's discretion.

SFAC Nos. 4 and 6 provided a foundation for two later FASB pronouncements: Statement of Financial Accounting Standards (SFAS) No. 116, "Accounting for Contributions Received and Contributions Made," and SFAS No. 117, "Financial Statements of Nonprofit Organizations." These two FASB pronouncements were issued in June 1993, and institutions were required to adopt them for fiscal years beginning after December 15, 1994 (fiscal 1996 for most colleges and universities). Once adopted, the statements in effect codified what is apparent to everyone: The primary difference between a nonprofit organization and a for-profit organization is that the former receives and reports contributions. In other important ways, the financial statements of nonprofit organizations resemble those of for-profit organizations:

- Unrestricted net assets are similar to retained earnings.
- Permanently restricted net assets are similar to common stock.
- Temporarily restricted net assets have characteristics of retained earnings as well as of common stock.

TABLE III-2

THE THREE CLASSES OF NET ASSETS ***(italics added)***

- ***"Permanently restricted net assets*** is the part of net assets of a nonprofit organization resulting (a) from contributions and other inflows of assets whose use by the organization is limited by donor-imposed stipulations that neither expire by passage of time nor can be fulfilled or otherwise removed by actions of the organization, (b) from other asset enhancements and diminishments subject to the same kinds of stipulations, and (c) from reclassifications from (or to) other classes of net assets as a consequence of donor-imposed stipulations." (SFAC No. 6, par. 92)
- ***"Temporarily restricted net assets*** is the part of net assets of a nonprofit organization resulting (a) from contributions and other inflows of assets whose use by the organization is limited by donor-imposed stipulations that either expire by passage of time or can be fulfilled and removed by actions of the organization pursuant to those stipulations, (b) from other asset enhancements and diminishments subject to the same kinds of stipulations, and (c) from reclassifications to (or from) other classes of net assets as a consequence of donor-imposed stipulations, their expiration by passage of time, or fulfillment and removal by actions of the organization pursuant to those stipulations." (SFAC No. 6, par. 93)
- ***"Unrestricted net assets*** is the part of net assets of a nonprofit organization that is neither permanently restricted nor temporarily restricted by donor-imposed stipulations — that is, the part of net assets resulting (a) from all revenues, expenses, gains, and losses that are not changes in permanently or temporarily restricted net assets and (b) from reclassifications from (or to) other classes of net assets as a consequence of donor-imposed stipulations, their expiration by passage of time, or their fulfillment and removal by actions of the organization pursuant to those stipulations. The only limits on unrestricted net assets are broad limits resulting from the nature of the organization and the purposes specified in its articles of incorporation (or comparable document for an unincorporated association) or bylaws and perhaps limits resulting from contractual agreements — for example, loan covenants — entered into by the organization in the course of its operations." (SFAC No. 6, par. 94)

In the past, financial reporting by colleges and universities focused on fund accounting, which took a stewardship view of reporting. Fund accounting operated on less than a full-accrual basis—that is, it did not require pledges to be recorded. The role of fund accounting was to allow the reader to ascertain whether funds had been spent according to the stipulations of donors, foundations, or the federal or state government. It did not focus on the institution as a whole, nor did it necessarily provide the reader with an understanding of the financial viability, liquidity, or solvency of the institution. The new statements—with the presentation of net assets based on their availability to the institution—place emphasis on information for decision making and take a much more forward-looking view of the organization.

SFAS Nos. 116 and 117 require major changes in the way nonprofit organizations report their financial results to the public. These changes are summarized in the next two sections of this chapter. (In addition, it should be noted that the AICPA's SOP 94-3, its consolidations work, and SFAS No. 124, on accounting for investments, also help bring nonprofit financial statements more in alignment with those of for-profit entities.)

REQUIREMENTS OF SFAS NO. 116

Colleges and universities receive contributions from many sources. Some donors place restrictions on the use of their contributions, and others do not. Under SFAS No. 116, "Accounting for Contributions Received and Contributions Made," the unconditional contributions an institution receives should be recognized in its

financial statements at their fair values as revenues or gains in the period received and as assets, decreases of liabilities, or expenses. If the donor places no restrictions on the use of a contribution, it should be recorded as an unrestricted net asset. If the donor places restrictions on a contribution, it should be recorded as a temporarily restricted net asset or as a permanently restricted net asset, depending on the nature of the donor's restrictions.

Many colleges and universities also receive pledges, or unconditional promises to give. Unconditional pledges should be recognized as revenue (equal to the net present value of the amounts expected to be received or realized) in an institution's financial statements as long as "verifiable documentation" exists. Such a pledge with payments due in future periods should be reported as restricted support unless the donor makes it clear that the pledge can be used to support current operations. SFAS No. 116 requires that institutions include footnotes in their financial statements that provide more information about their pledges.

Conditional promises to give should be reported in the institution's financial statements when the conditions on which they depend have been substantially met. In some cases, a donor's stipulations may be ambiguous, in which case, the pledge would be presumed to be a conditional promise to give.

CONTRIBUTED SERVICES

Some institutions may receive services, such as volunteer labor, instead of cash gifts from donors. They should recognize in their financial statements any contributed services that (1) create or enhance nonfinancial assets or (2) otherwise would need to be purchased because they are provided by individuals with specialized skills. (It should be noted that many volunteer services do not meet these requirements and therefore need not be recorded as contributed services.) The FASB also requires institutions to include footnotes in their financial statements about the nature of contributed services they have received. The purpose of this requirement is to reflect the expenses that would be incurred by the institution if these services were not donated.

COLLECTIONS

Some institutions have museums, collections of art, or other collectible items. Collectible items need not be recognized in the institution's financial statements if all of the following conditions are met:

- The collectible items are held for public exhibition, education, or research to further public service.
- They are protected, kept unencumbered, cared for, and preserved.
- They are subject to an organizational policy that requires the proceeds from the sale of the collectible items to be used to acquire other items for the collection.

If the collectible items do not meet all of these conditions, they must be capitalized and recorded on the institution's financial statements. If collectible items are contributed, they should be reported as revenues or gains at the verifiable value of the items.

CONTRIBUTIONS MADE

SFAS No. 116 also applies to for-profit organizations that may make contributions. If either a for-profit or a nonprofit organization makes a contribution, this should be recorded in the donor's financial statements as an expense in the period made and as a decrease of assets or increase of liabilities, depending on the form of the contribution. Likewise, an unconditional pledge or promise to make a contribution should be recorded as an expense with an accompanying liability until the pledge is fulfilled.

In summary, the objective of SFAS No. 116 was to clarify the notion of contributions and when the organization should recognize such contributions as revenue.

REQUIREMENTS OF SFAS NO. 117

SFAS No. 117, "Financial Statements of Nonprofit Organizations," requires an organization to present three financial statements: a statement of financial position, a statement of activities, and a statement of cash flows. With SFAS No. 117, the FASB's objective is "...to enhance the relevance, understanding, and comparability of financial statements issued by those organizations." (SFAS No. 117, Summary) The purpose of the three statements is to "...provide relevant information to meet the common interests of donors, members, creditors, and others who provide resources to nonprofit organizations." (SFAS No. 117, par. 4)

The format required by SFAS No. 117 focuses on the institution as a whole in order to provide the reader with a clear picture of the institution's financial condition to enable them to make informed decisions. To a large extent, society's understanding of the financial condition of its higher education institutions depends on the completeness and utility of their financial statements. The financial condition of each institution is measured in terms of its assets and liabilities, revenues and expenses, and its cash flows. The three required statements give users information that often was lacking in the past or difficult to discern in the previous method of reporting.

STATEMENT OF FINANCIAL POSITION

The statement of financial position is essentially a balance sheet. Its focus is on the organization as a whole. It presents, at a given point in time, (1) the major classes of assets and liabilities, (2) the net assets of the organization, and (3) the total of each of the three classes of net assets described in the FASB's SFAC No. 6, "Elements of Financial Statements":

- Permanently restricted net assets (such as true endowment funds).
- Temporarily restricted net assets (such as term endowments and other assets that are donor-restricted for a specified time or purpose).
- Unrestricted net assets.

According to the FASB, the statement of financial position provides information about "the organization's ability to continue to provide ser-

TABLE III-3

IMPORTANT DEFINITIONS

SFAS No. 116, "Accounting for Contributions Received and Contributions Made," includes many definitions. Some important ones include:

- **Contribution:** "...unconditional transfer of cash or other assets to an entity or a settlement or cancellation of its liabilities in a voluntary nonreciprocal transfer by another entity acting other than as an owner." (SFAS No. 116, par. 5)
- **Promises to give:** "...a written or oral agreement to contribute cash or other assets to another entity; however, to be recognized in financial statements there must be sufficient evidence in the form of verifiable documentation that a promise was made and received." (SFAS No. 116, par. 6)
- **Donor-imposed condition (on a transfer of assets or a promise to give):** "...specifies a future and uncertain event whose occurrence or failure to occur gives the promisor a right of return of the assets transferred or releases the promisor from its obligation to transfer assets promised." (SFAS No. 116, par. 7)
- **Donor-imposed restriction:** "...limits the use of contributed assets; it specifies a use that is more specific than broad limits resulting from the nature of the organization, the environment in which it operates, and the purposes specified in its articles of incorporation or bylaws or comparable documents for an unincorporated association." (SFAS No. 116, par. 7)

vices and [its] liquidity, financial flexibility, ability to meet obligations, and needs for external financing." (SFAS No. 117, par. 9) Liquidity is defined as "an asset's or liability's nearness to cash," and financial flexibility "is the ability of an entity to take effective actions to alter amounts and timing of cash flows so it can respond to unexpected needs and opportunities." (SFAS No. 117, footnote 3) Colleges and universities are encouraged to reflect liquidity in this statement by one of the following methods:

- Classifying assets as current and noncurrent.
- Sequencing assets and liabilities according to liquidity.
- Disclosing relevant information about liquidity in the footnotes.

Colleges and universities must present their assets in the statement of financial position as permanently or temporarily restricted based on donor-imposed restrictions or restrictions imposed by law that effectively extend donor restrictions to the respective net assets, rather than on board-designated restrictions. In the absence of donor-imposed restrictions, the statement of financial position should classify assets as unrestricted. Institutions can, however, disclose self-imposed limitations (such as quasi-endowment or amounts designated for other specified areas) in the footnotes or on the face of the statement.

STATEMENT OF ACTIVITIES

The statement of activities provides information about the changes in the three classes of net assets and how the institution has used these resources to provide services during the previous year. This information should help donors and creditors evaluate the institution's performance, its service efforts, and how it has carried out its stewardship responsibilities. (SFAS No. 117, par. 17)

At a minimum, the statement of activities must report the amount of the change in each of the permanently restricted net assets, temporarily restricted net assets, unrestricted net assets, and total net assets for the period. An institution can report a "measure of operations," which might be similar to "net income from continuing operations" found in the for-profit sector. This measure should attempt to relate revenues and expenses for the current period to provide the user with information about whether the institution is operating within its means. If such a measure is provided, the statement of activities still must include the amount of the total change in unrestricted net assets for the period (which also might include nonoperating activity, such as gifts or transfers of net assets from temporarily restricted net assets).

The FASB provided for flexibility in the statement of activities. As long as an institution meets the minimum requirements, it may classify items as "operating and nonoperating, expendable and nonexpendable, earned and unearned, recurring and nonrecurring, or in other ways." (SFAS No. 117, par. 23)

The statement of activities, in particular the column for unrestricted net assets, is basically the "income statement" of the nonprofit organization. It enables institutional officials and others not only to assess whether the college or university is operating within its available resources, but also to evaluate the costs of operating various programs.

STATEMENT OF CASH FLOWS

The statement of cash flows provides information about an institution's cash receipts and cash payments. Like those required of for-profit entities, the statement of cash flows for nonprofit organizations segregates the activities of the organization into three categories: cash flows from operations, investing, and financing activities.

SFAS No. 117 amends SFAS No. 95, "Statement of Cash Flows," to extend its provisions to nonprofit organizations, including colleges and universities. The amendments to SFAS No. 95 in 117 are as follows:

- The terms "statement of activities" and "change in net assets" apply to a nonprofit organization; the terms "income statement" and "net income" apply to a business enterprise.
- Cash flows from financing activities include "receipts from contributions and investment income that by donor stipulation are restricted for the purposes of acquiring, constructing, or improving property, plant, equipment, or other long-lived assets or establishing or increasing a permanent endowment or term endowment." (SFAS No. 117, par. 30)

By studying the cash flow statement, board members and senior administrators can assess the institution's ability to meet its ongoing cash needs from operations or through other forms of financing. If cash flows from operations are negative, for example, it implies that the institution must be able to meet this cash-flow deficit through additional contributions or by borrowing funds.

THE FINANCIAL REPORTING PROCESS

In its Concept Statements, the FASB developed a framework for the financial reporting process. In SFAC No. 4, "Objectives of Financial Reporting by Nonbusiness Organizations," which was summarized briefly earlier in this chapter, the FASB noted many similarities between nonbusiness organizations, such as colleges and universities, and business enterprises. The principal difference is the way they obtain resources. Those who provide resources to nonbusiness organizations do so not for economic benefits but rather because they are interested in furthering the organization's charitable goals.

The FASB noted that resource providers (or governing boards) frequently specify how a nonbusiness organization can spend its resources. Usually, restrictions take one of two forms: donors restrict their gifts, or the nature of the organization causes its budgetary appropriations to be specified for a particular use. The FASB indicated that budgets are very important to nonbusiness organizations not only for controlling resources but also in obtaining them. For example, colleges and universities use their budgets as a tool to help set tuition levels.

SFAC No. 4 also discusses the limitations of financial reporting. Whether by business entities or nonbusiness organizations, financial reporting is based on estimates and judgments. It is not an exact science. In addition, financial reporting reflects events that already have occurred and makes no predictions about future performance. As an information system, however, financial reporting should be a good predictor of future activities and cash flows because its purpose is to help external users make decisions. Moreover, financial reporting provides only one kind of information. For some external users, economic, social, and political information obtained from other sources may be equally important in evaluating the performance of a nonbusiness organization.

There is an additional limitation on the financial reports of nonbusiness organizations. The external market helps measure the quality of goods and services business entities provide. That is, the market reflects in its stock prices the profit business entities produce (or fail to produce). Nonbusiness organizations have no such objective, external market indicators.

Underlying SFAC No. 4 are the needs of *users* for financial information. Meeting their needs is important. The FASB defined four principal groups of users in SFAC No. 4:

- *Resource providers*, including "those who are directly compensated for providing resources—lenders, suppliers, and employees—and those who are not directly and proportionately compensated—members, contributors, and taxpayers." SFAC No. 4, par. 29)
- *Constituents*, including "those who use and benefit from the services rendered by the organization." (SFAC No. 4, par. 29)
- *Governing and oversight bodies*, representing "those responsible for setting policies and for

overseeing and appraising managers of nonbusiness organizations." (SFAC No. 4, par. 29) Governing and oversight bodies include not only boards of trustees but also governmental regulatory bodies, legislatures, accrediting agencies, and others.

- *Managers* who are "responsible for carrying out the policy mandates of governing bodies and managing the day-to-day operations of an organization." (SFAC No. 4, par. 29)

These four groups of users share a common interest. They want to know about the efficiency and effectiveness of a college or university in providing services—and its ability to continue to do so. For example, contributors may use the institution's financial reports to make decisions about their continued support. Lenders want to know whether the organization can meet its debt service. Governing boards use financial reports to help them decide whether they should change the policies they have set and as a performance indicator for the institution's senior administrators. Financial reports should address the needs of these various users.

Some financial information is beyond the scope of SFAC No. 4. For example, the FASB noted that "governing bodies and managers need information to evaluate properly the competing requests for funding of capital projects. They also need information to assist them in complying or overseeing compliance with spending mandates established by budgetary appropriations or donor or grantor restrictions. They need to know how much of a budgetary appropriation or restricted grant is unspent or uncommitted. They need to know that restricted resources were expended or committed in compliance with related mandates." (SFAC No. 4, par. 32) Such reporting—that is, for internal users—is beyond the scope of SFAC No. 4.

FOUR OBJECTIVES OF FINANCIAL REPORTING

SFAC No. 4 discusses four objectives of financial reporting. These four objectives stem primarily from the needs of external users. First, however, the FASB defines the role of financial reporting as follows:

"The role of financial reporting in the economy and society is to provide information that is useful in making decisions about allocating scarce resources, not to determine what those decisions should be.... The role of financial reporting requires it to provide neutral information." (SFAC No. 4, par. 34) This point emphasizes once again that financial reporting is not an answer but rather provides the information for decision making.

The first objective of financial reporting is to provide useful information to resource providers and others to help them make resource-allocation decisions. The FASB notes that resource providers generally cannot prescribe the type of information they want. However, their decisions affect not only the organization but also, because resources are scarce, society as a whole. The FASB also notes that not all resource providers understand to the same degree the information financial reporting provides. According to the FASB, however, "Financial reporting should provide information that can be used by all who are willing to learn to use it properly." (SFAC No. 4, par. 37)

The second objective of financial reporting is to provide information to resource providers and others to help them assess the services an institution provides and its ability to continue providing those services. The FASB notes, "Resources are the lifeblood of an organization in the sense that it uses resources to provide services.... Although decisions of potential and present resource providers to provide or continue to provide resources involve expectations about future services of an organization, those expectations commonly are based at least partly on evaluations of past performance. Thus, resource providers tend to direct their interest to

information about the organization's resources and how it acquires and uses resources." (SFAC No. 4, par. 39) This historical information is provided in a college or university's financial reports.

The third objective of financial reporting is to provide information to resource providers and others to help them assess how the institution's managers have carried out their stewardship and other responsibilities. According to the FASB, "Managers of an organization are accountable to resource providers and others not only for the custody and safekeeping of organization resources but also for their efficient and effective use. Those who provide resources to nonbusiness organizations do not have a profit indicator to guide their resource-allocation decisions.... They must look to managers to represent their interests and to make operating cost-benefit judgments that achieve the objectives of the organizations with minimum use of resources. Managers also are accountable for compliance with statutory, contractual, or other limitations." (SFAC No. 4, par. 40)

However, the FASB also notes in SFAC No. 4 the limitations of financial reporting in meeting this objective. The success or failure of a college or university, for example, is due to numerous factors, and the ability of its administrators is only one of these factors. Events that are beyond the control of administrators and the performance and skills of their predecessors also contribute to an institution's success or failure. However, the financial markets look at the relative success of college and university administrators as an indicator. Having those with the requisite management skills in charge implies that the institution is more likely to use its resources effectively and efficiently.

The fourth objective of financial reporting is to provide information about economic resources, obligations, net resources, and changes in these indicators. Such information helps resource providers identify an institution's financial strengths and weaknesses, evaluate its performance, and assess its ability to continue providing services. This information also includes an institution's cash flows. In addition, the FASB notes that providing information about net resources and changes in them indicates an institution's performance during a period:

> "Financial reporting should provide information about the relation between inflows and outflows of resources during a period. Those who provide resources to a nonbusiness organization and others want to know how and why net resources changed during a period. To meet that need, financial reporting must distinguish between resource flows that are related to operations and those that are not. In this way, financial reporting may provide information that is useful in assessing whether the activities of a nonbusiness organization during a particular period have drawn upon, or have contributed to, past or future periods. Thus, it should show the relation of resources used in operations of a period to resource inflows available to finance those operations. Similarly, it should provide information about changes in resources that are not related to operations. For example, resource providers to colleges and universities need information about changes in an organization's endowment and plant to understand more fully the changes in its net resources during a period." (SFAC No. 4, par. 49)

The FASB notes that providing information about an organization's service efforts and accomplishments is related to the fourth objective of financial reporting. Also related is providing information about liquidity. According to the FASB, "Financial reporting should provide information about how an organization obtains and spends cash or other liquid resources, about its borrowing and repayment of borrowing, and about other factors that may affect its liquidity." (SFAC No. 4, par. 54) In addition, the FASB noted that the explanations often provided in footnotes are an important element of financial reporting.

FASB No. 117 helps align financial reporting in the nonprofit sector more closely with that of

the for-profit sector. The emphasis is on the institution as a whole and the similar statements found in the for-profit sector. Each of the statements—the statement of financial position, the statement of activities, and the statement of cash flows as well as the accompanying notes—provides users with the information necessary to assess the liquidity, solvency, and financial flexibility of the institution. Institutions that have developed statements that tell their unique story are in a better position to affect their ability to continue to receive funds from the various resource providers.

In *Reinventing the University: Managing and Financing Institutions of Higher Education,* Robert M. Turner and Kenneth D. Williams note that "the standard setting bodies have provided the nonprofit industry with the opportunity to play a major role in how methods of accountability and evaluation develop. Institutions that actively play a role in this process will be able to develop meaningful systems of reporting that enhance not only external financial reports, but also internal reports that are critical to carrying out their managerial and governing responsibilities effectively."

4

STATEMENT OF FINANCIAL POSITION

The statement of financial position, or balance sheet, is a snapshot of the financial condition of an institution at a specific point in time, generally the end of the fiscal year. According to the FASB, this statement should provide users with information about an institution's ongoing ability to provide services, as well as information on its liquidity, financial flexibility, and financing needs. (SFAS No. 117, par. 9)

The statement of financial position must display the following amounts:

1. Total assets,
2. Total liabilities,
3. Total net assets, and
4. Totals for of each of the three classes of net assets:
   - Unrestricted
   - Temporarily restricted
   - Permanently restricted

Most institutions aggregate all assets of each type, presenting the financial statements in a highly condensed and meaningful format similar to those of a commercial enterprise. For example, such statements often present cash as a single, total amount (rather than a separate amount by fund). Likewise, investments appear as a single number on the statement of financial position, providing a clear picture of the resources of the institution. The various liabilities of the institution also are presented in a very condensed format so that it is relatively easy to determine the total short-term and long-term obligations of the institution.

Included among the institution's assets are contributions receivable (or pledges), as required by SFAS No. 116. With the adoption of SFAS No. 116, "Accounting for Contributions Received and Contributions Made," the statement of financial position must reflect all unconditional promises to give to an institution as a receivable net of allowance for uncollectible amounts. The receivable also is discounted to reflect the current net realizable value of such commitments.

Although some institutions simply present a total for each of the three net asset classes on the face of their statements of financial position, others want readers to be able to distinguish among the various types of unrestricted net assets so they do not mistakenly think large amounts of unrestricted net assets are available when these already have been committed to operating needs. For example, unrestricted net assets include an institution's net investment in plant (its property, plant, and equipment less

Prior to the adoption of SFAS No. 117, institutions showed individual fund balances on the statement of financial position. This presentation emphasized the institutions' accountability as stewards of various funds under so-called "fund accounting." The statement of financial position under SFAS No. 117 emphasizes the degree to which donor-imposed restrictions of net assets exist.

any related debt). Unrestricted net assets also include funds the board or administrators may designate for the institution's specific current or future needs. Also included in unrestricted net assets are quasi-endowment funds. Such amounts are designated by the board from unrestricted sources to serve as part of the capital of the institution. While these could be spent at the discretion of the board, they have been designated as endowment.

An institution also may choose to present the various categories of its temporarily restricted net assets in the footnotes or on the statements themselves. Temporarily restricted net assets also include amounts that represent the realized and unrealized gains on the permanent endowment of the institution on which the donor has restricted income for some future purpose. Also included are any unexpended endowment income or current gifts for purposes for which the institution has yet to make expenditures. Finally, this category includes contributions receivable in future periods that ultimately may be used to support the operating activities of the institution. However, because the amounts are not yet available, there is a de-facto time restriction on their use. Accordingly, they are included among the temporarily restricted net assets.

Permanently restricted net assets include true endowment funds. These are gifts from donors who have specified that the principal (and sometimes the income) may not be spent. In certain states, the laws also may require that a portion of the realized and unrealized gains on investments must be added to permanently restricted net assets as a preservation of that capital against the effects of inflation (Rhode Island law requires such an adjustment).

STATEMENT OF FINANCIAL POSITION FOR SANJO UNIVERSITY: A WALK THROUGH

Exhibit A shows the statement of financial position for SanJo University, a hypothetical institution. This statement of financial position displays the assets, liabilities, and the net assets of the institution in a fairly simple and understandable format. You will see that the statement has two columns, one for fiscal 1996 totals and one for fiscal 1995 totals (1995 totals are presented for comparison). There are three categories—assets, liabilities, and net assets—indicated in bold type on the statement. SanJo's total assets for fiscal 1996 are $407,935, while its total liabilities are $66,522, and its total net assets are $341,413.[1] You also will note that the university's net assets in fiscal 1996 include unrestricted net assets of $157,212, temporarily restricted net assets of $103,537, and permanently restricted net assets of $80,664.

SanJo's unrestricted net assets of $157,212 in fiscal 1996 include its basic working capital as well as some funds the board and/or administrators have earmarked for designated purposes (such as deferred maintenance, support for various programs, and construction projects). Its unrestricted net assets also include the unrestricted portion of the endowment fund as well as the institution's net investment in property and equipment.

SanJo's temporarily restricted net assets of $103,537 in fiscal 1996 include donor restricted amounts, which may include such items as unexpended restricted gifts and unexpended endowment income. The temporarily restricted net assets figure also includes the accumulated realized and unrealized gains on the university's permanent endowment funds that are restricted as to use. In addition, SanJo has identified separately the pledges receivable that it eventually will have available.

SanJo also has chosen to separate its permanently restricted net assets of $80,664 in fiscal 1996 into two categories—net assets that represent permanently restricted endowment funds and pledges receivable. By definition, the only portion of the endowment funds included here is the original corpus of gifts plus

[1] Throughout this book the numbers for the financial statements are in thousands. That is, $341,413 actually is $341,415,000. We have dropped the zeros in the interest of readability.

EXHIBIT A

STATEMENT OF FINANCIAL POSITION

SanJo University
Statement of Financial Position
June 30, 1996 and 1995 (in thousands)

Assets	**1996**	**1995**
Cash and cash equivalents	$14,866	$15,650
Accounts receivable, net	1,010	851
Short-term investments	11,993	11,327
Inventories	1,109	1,062
Prepaid expenses and other assets	2,130	2,148
Pledges receivable, net	15,333	15,285
Student loans receivable, net	2,716	2,764
Long-term investments, at market	249,152	240,743
Land, buildings and equipment, net	109,626	96,211
Total assets	$407,935	$386,041
Liabilities		
Accounts payable and accrued expenses	5,903	7,188
Deposits and deferred revenues	2,897	2,759
Postretirement benefits	6,312	6,029
Federal student loan funds	2,831	2,782
Long-term debt	48,579	49,720
Total liabilities	66,522	68,478
Net Assets		
Unrestricted	157,212	147,342
Temporarily restricted	103,537	93,522
Permanently restricted	80,664	76,699
Total net assets	341,413	317,563
Total liabilities and net assets	$407,935	$386,041

any income or gains that the donor, or state law, has determined must be added to the corpus. The pledges receivable amount shown here represents amounts that once received will become part of the corpus of the endowment fund.

ANALYZING THE STATEMENT OF FINANCIAL POSITION

The FASB noted in SFAS No. 117 that the statement of financial position should provide users with information about an institution's ongoing ability to provide services as well as information on its liquidity, financial flexibility, and financing needs. Information on liquidity should be provided in at least one of three ways: (1) by classifying assets as current or noncurrent, (2) by disclosing information in the footnotes about liquidity, or (3) by sequencing assets according to their nearness of conversion to cash and liabilities according to their nearness to maturity and resulting use of cash. (This was the method SanJo University used.) Information on an institution's ongoing ability to provide services, demonstrate financial flexibility, and meet its financing needs is less readily apparent, but generally relates to its financial strength.

The overall strategic question that emerges from a review of the statement of financial position is this: *Are existing resources sufficient to enable the institution to fulfill its mission?*

Let us first consider this question broadly and then more specifically for SanJo University. A relatively simple indicator of an institution's financial strength that can be gleaned from its statement of financial position is the growth in net assets and in each category of net assets. For example, the net assets of SanJo University increased overall as well as in almost every category from 1995 to 1996, as can be seen in Chart IV-1. (Chart IV-1 presents detailed information from the footnotes to the financial statements on the composition of net assets for SanJo University.)

The growth in SanJo University's net assets suggests the university may be in a relatively strong financial position. Ratio analysis can help support answers to questions about the sufficiency of an institution's resources. Using ratio analysis, we will explore the various dimensions of the university's financial strength in greater detail in Chapter 7.

CHART IV-1

ANALYZING THE COMPOSITION OF NET ASSETS

Net Assets of SanJo University*

Net Assets	1996 Total	1995 Total	Percentage Change
Unrestricted:			
Available for operating needs	$5,396	$4,744	14%
Designated funds	$4,500	$10,300	(56%)
Funds functioning as endowment	$86,269	$85,807	1%
Net investment in plant	$61,047	$46,491	31%
Subtotal	$157,212	$147,342	7%
Temporarily restricted:			
Accumulated endowment gains	$60,476	$43,637	39%
Donor restricted amounts	$37,890	$44,729	(15%)
Pledges receivable	$5,171	$5,156	1%
Subtotal	$103,537	$93,522	11%
Permanently restricted:			
Endowment & similar funds	$70,517	$66,570	6%
Pledges receivable	$10,147	$10,129	1%
Subtotal	$80,664	$76,699	5%
Total net assets	$341,413	$317,563	8%

*From Footnote 7 in Appendix A

5

STATEMENT OF ACTIVITIES

The statement of activities presents aggregated information about the revenues, expenses, and other sources of funds of an institution. The basic requirements established by the FASB for the statement of activities are the following:

- The statement must report the total amount of the changes in each of the net asset groups (unrestricted, temporarily restricted, and permanently restricted net assets).
- The statement must show the amount of the total changes in all net assets for the period.
- The statement must show all expenses as if expended from unrestricted net assets. To the extent that temporarily restricted net assets are available to meet current expenses, they must be shown as having been "released" from restrictions and reclassified into unrestricted resources.

The FASB did not prescribe a single format to use for the statement of activities. As a result, institutions have used many different formats. However, despite the variety of formats, the new statement of activities is easier to understand than its predecessor, which reported financial information by funds.

Under SFAS No. 117, the FASB permits but does not require the presentation of a "measure of operations" in the statement of activities. Most institutions manage their financial affairs by establishing operating budgets and measuring their operating performance against their budget. For that reason, many institutions are presenting within their statement of activities a "measure of operations," which is linked directly or indirectly to the budget.

Overall, the statement of activities captures information about the operating activity of an institution, its investment management results, and its fund-raising activities. Therefore, the four major areas most institutions will want to measure in their statement of activities are overall results, operating results, investment performance, and fund-raising results.

The format the institution chooses can disguise or emphasize each or all of these important areas. Although various higher education institutions are using several different formats to present this information, three methods are commonly found in financial reports. (A description of these three formats appears at the end of this chapter.)

STATEMENT OF ACTIVITIES FOR SANJO UNIVERSITY: A WALK THROUGH

Exhibit B shows the statement of activities for SanJo University. The statement contains four columns for fiscal year 1996 (Unrestricted, Temporarily Restricted, Permanently Restricted, and 1996 Total) and, for comparison, presents another column for fiscal 1995 totals. SanJo's statement of activities has three sections—Operating Revenues, Operating Expenses, and Nonoperating Activities—which are indicated in bold type on the statement.

Reading across the statement of activities, you will see that total unrestricted operating revenues for fiscal 1996 are $70,220; temporarily restricted operating revenues are $2,772; there are no permanently restricted operating revenues in fiscal 1996; and total operating revenues for fiscal 1996 are $72,992. Similarly, total

EXHIBIT B

THE STATEMENT OF ACTIVITIES

SanJo University
Statement of Activities
For the year ended June 30, 1996 with comparative totals for 1995
(in thousands)

	Unrestricted	Temporarily Restricted	Permanently Restricted	1996 Total	1995 Total
Operating Revenues					
Tuition and fees	$54,298			$54,298	$49,077
University sponsored financial aid	(5,145)			(5,145)	(4,446)
Donor sponsored financial aid	(9,988)			(9,988)	(8,892)
Net tuition and fees	39,165			39,165	35,739
Sales and services of auxiliaries	12,099			12,099	10,628
Government grants and contracts	1,991			1,991	1,684
Private gifts and grants	4,084	2,639		6,723	5,647
Long-term investment income	4,110	4,943		9,053	10,152
Investment gains used for operations	1,191	1,456		2,647	963
Other income	1,314			1,314	1,285
Net assets released from restrictions	6,266	(6,266)			
Total operating revenues	70,220	2,772		72,992	66,098
Operating Expenses					
Instruction and research	27,619			27,619	25,783
Athletics	6,001			6,001	5,499
Academic support	6,367			6,367	6,321
Student services	6,085			6,085	5,643
Institutional support	10,648			10,648	10,472
Auxiliary enterprises	10,020			10,020	8,845
Total operating expenses	66,740			66,740	62,563
Increase in net assets from operating activities	3,480	2,772		6,252	3,535
Nonoperating Activities					
Investment gains reinvested	5,024	8,174		13,198	1,793
Capital gifts	934	1,921	3,965	6,820	8,511
Other	(1,197)	(1,223)		(2,420)	(969)
Net assets released from restrictions	1,629	(1,629)			
Increase in net assets from nonoperating activities	6,390	7,243	3,965	17,598	9,335
Net increase in net assets for the year before change in accounting	9,870	10,015	3,965	23,850	12,870
Effect of changes in accounting:					
Contributions pledged					15,285
Postretirement benefits					(5,645)
Net increase in net assets	9,870	10,015	3,965	23,850	22,510
Net assets at beginning of year	147,342	93,522	76,699	317,563	295,052
Net assets at end of year	$157,212	$103,537	$80,664	$341,413	$317,562

The accompanying notes are an integral part of the financial statements.

unrestricted operating expenses for fiscal 1996 are $66,740; there are no temporarily or permanently restricted operating expenses in fiscal 1996; and 1996 total operating expenses are $66,740. Midway down the statement of activities in Exhibit B, you will see "Increase in net assets from operating activities" with a 1996 total of $6,252. Toward the bottom are the items "Net increase in net assets" ($23,850 is the 1996 total), "Net assets at beginning of year" ($317,563), and "Net assets at end of year" ($341,413).

ANALYZING THE STATEMENT OF ACTIVITIES

According to the FASB, "the information provided in a statement of activities, used with related disclosures and information in the other financial statements, helps donors, creditors, and others to (1) evaluate the organization's performance during a period, (2) assess an organization's service efforts and its ability to continue to provide services, and (3) assess how an organization's managers have discharged their stewardship responsibilities and other aspects of their performance." (SFAS No. 117, par. 17)

The fundamental question the statement of activities answers is this: *How did the institution use its resources to provide services to its constituents?* Board members and administrators evaluating the answer to this broad question may find the following eight specific questions helpful. We also have provided various indicators and other factors to consider.

1. **Overall, how did SanJo University perform financially for the year?** This question considers a broad perspective of the university's financial performance for the year. The following indicators are based on the increase in net assets for the year as one measure of the university's financial performance.
   - *Indicator A:* Increase in net assets as a percentage of the beginning balance of net assets.
   - *Indicator B:* Increase in unrestricted net assets as a percentage of the beginning balance of unrestricted net assets.
   - *Indicator C:* Increase in temporarily restricted net assets as a percentage of the beginning balance of temporarily restricted net assets.
   - *Indicator D:* Increase in permanently restricted net assets as a percentage of the beginning balance of permanently restricted net assets.

Factors to Consider:

- The net increase in net assets should be increasing at a rate exceeding inflation and, hopefully, at a much quicker pace if the institution is to sustain real progress. An increase in net assets enhances the financial strength of the institution, because these net assets provide the institution with financial flexibility.
- It also is important to focus on the *components* of net assets, especially (1) unrestricted net assets (assets on which donors have imposed no restrictions, although the board may have designated some of these funds, or they may be needed to meet certain contractual arrangements) and (2) permanently restricted net assets (assets on which donors have imposed permanent restrictions). Unrestricted and permanently restricted net assets also should increase at a rate exceeding inflation. Temporarily restricted net assets are less important to focus on, because they reflect assets that are restricted only for a period of time or for a specific purpose specified by the donor.

SanJo University Analysis

Overall, how did SanJo University perform financially in fiscal 1996? The university's net increase in net assets for the year was $23,850, or 7.5 percent of the total net assets at the beginning of the year, which were $317,563. (See indicator A on Chart V-4 on page 30.) In addition, each of the three net asset groups—unrestricted, temporarily restricted, and permanently restricted—showed growth. (See indicators B, C, and D on Chart V-4 on page 30.) In all cases, the level of growth exceeded that of inflation, which was

roughly 3 percent for the period. These increases in net assets for SanJo University in fiscal 1996 enhance its financial strength.

Chart V-4 summarizes the information needed from SanJo University's statement of activities to determine the answer to Question 1. It also contains applicable percentages.

2. **Is SanJo University living within its means?** This question considers whether the university is able to meet its operating expenses with its operating revenues.
   - *Indicator A:* Increase or decrease in net assets from operating activities.

Factors to Consider:

- A net increase from operating activities indicates the institution's operating revenues exceeded its expenses, and the institution generally is living within its means.
- An operating surplus may be channeled into long-term reinvestment in the institution if the board designates certain funds for quasi-endowment or for the physical plant.
- If an institution is not living within its means, it must find a way to meet the deficit in the short term and create a surplus in future years.

Another important question is this: ***Did the institution live within its budget?*** In the past, many institutions have not budgeted in a manner consistent with their external financial reports; they have not listed depreciation as a budgeted expense, for example. Now that institutions have adopted the financial-reporting models required by the FASB, more are likely to do so. Trustees then can look to the reported operating surplus or deficit as a meaningful measure.

SanJo University Analysis

SanJo University's operating revenue in fiscal 1996 exceeded its operating expenses (as can be seen in Chart V-5 on page 31), so the university appears to be living within its means. SanJo also can channel a portion of its surplus for the year into quasi-endowment funds or the physical plant, both of which would enhance the university's long-term financial position.

Chart V-5 summarizes the key information from SanJo University's statement of activities for this question (see Indicator A).

3. **How reliant is the institution on each of its operating revenue sources?** This question considers the diversity and breadth of the university's revenue stream.
   - *Indicator A:* Each operating revenue source (tuition and fees, private gifts and grants, and so forth) as a percent of total operating revenues.

CHART V-4

INCREASE IN NET ASSETS FOR SANJO UNIVERSITY

(For Question 1, indicators B, C, D, and A)

Net Asset Category	Increase in Net Assets	Net Assets at Beginning of Year	Percent Increase
Unrestricted	$9,870	$147,342	6.7% *(B)*
Temporarily Restricted	$10,015	$93,522	10.7% *(C)*
Permanently Restricted	$3,965	$76,699	5.2% *(D)*
1996 Total	$23,850	$317,563	7.5% *(A)*

CHART V-5

KEY INFORMATION FROM SANJO UNIVERSITY'S STATEMENT OF ACTIVITIES

(For Question 2, Indicator A)

Line Item	1996 Totals
Total Unrestricted Operating Revenues	$70,220
Total Unrestricted Operating Expenses	$66,740
Increase in Unrestricted Net Assets From Operating Activities	$ 3,480 *(A)*

Factors to Consider:

- Although it may seem to be an obvious point, it is important to understand that the broader an institution's revenue streams, the less exposure it has to fluctuations in any one source of revenue.
- Each revenue source has a different life cycle. For example, tuition revenues usually operate in two-year or four-year cycles (for two-year and four-year programs); research revenues generally operate in cycles corresponding to the terms of major contracts and grants; and endowment income operates in perpetuity. The mix of short-term and long-term revenue sources and the volatility of each source can be important when considering new long-term commitments.

SanJo University Analysis

How reliant is SanJo University on each of its operating revenue sources? Fifty-six percent of the university's revenue comes from tuition and fees. This indicates SanJo depends heavily on such revenue, although not to the extent of some private institutions. The university will need to monitor this dependence and consider taking corrective steps if it becomes more dependent on this revenue source.

Chart V-6 below summarizes key information from SanJo University's statement of activities for Indicator A for Question 3 and provides the applicable percentages.

4. **Do operating expenses by cost category (instruction, institutional support, and so forth) reflect institutional priorities?** This question considers whether the institution's spending patterns reflect its mission.
   - *Indicator A:* Each operating expense as a percent of total operating expenses.

Factors to Consider:

- Instruction is central to the mission of most colleges and universities, and as a result, the amount spent on instructional expenses should be as high as possible in relation to

CHART V-6

THE UNIVERSITY'S DEPENDENCE ON OPERATING REVENUE SOURCES

(For Question 3, Indicator A)

Operating Revenues	1996 Totals	Percentage of Total
Net tuition and fees	$39,165	56% *(A)*
Sales and services of auxiliaries	$12,099	17% *(A)*
Government grants and contracts	$1,991	3% *(A)*
Private gifts and grants	$4,084	6% *(A)*
Long-term investment income	$4,110	6% *(A)*
Investment gains used for operations	$1,191	1% *(A)*
Other income	$1,314	2% *(A)*
Donor-restricted assets availed of	$6,266	9% *(A)*
Total operating revenues	$70,220	100%

total expenses. In addition to instructional operating expenses as a percent of total operating expenses, institutions also may want to assess instructional expenses per full-time equivalent (FTE) student.

- Similarly, many institutions are paying close attention to institutional support expenses, trying to maintain or improve service but at a lower cost. Included in institutional support expenses are such items as legal costs, fiscal operations, general administrative services, purchasing, security, development, and community relations.
- If it seems appropriate after analysis, the board may want to take steps to shift operating expenses over time to reflect institutional priorities more accurately. Also, the board may decide to focus on a certain area, such as student financial aid, understanding that although its action may be very expensive over the long-term, it nonetheless meets a stated goal—such as increasing the diversity of the student body.
- Expenses also may be categorized as natural (salaries), although they must be categorized as functional (instruction and research). *Natural* expense classifications allow board members to analyze such inflationary factors as salary increases and fringe benefits, while *functional* expense categories allow board members to analyze the full cost of program activities. Board members may want to review natural expenses and make certain these reflect institutional priorities.

Other key questions related to institutional revenues and expenses include the following:

- Are revenues increasing at a faster rate than expenses?
- Are expenses increasing in line with inflation or more rapidly (as has often been the case in higher education)?

SanJo University Analysis

Do SanJo University's operating expenses reflect its priorities? At 41 percent, the highest proportion of the university's expenses are being incurred for instruction and research. This suggests that the university focuses its activities on teaching and research. At 16 percent, the second highest proportion of the university's expenses are being incurred for institutional support (which includes certain administrative functions). SanJo University may want to assess more carefully—and possibly reduce—its spending on institutional support.

Chart V-7 summarizes the relevant information from SanJo University's statement of activi-

CHART V-7

FISCAL 1996 OPERATING EXPENSES FOR SANJO UNIVERSITY

(For Question 4, Indicator A)

Operating Expenses	1996 Total	Percentage of Total
Instruction and research	$27,619	41% *(A)*
Athletics	$6,001	9% *(A)*
Academic support	$6,367	10% *(A)*
Student services	$6,085	9% *(A)*
Institutional support	$10,648	16% *(A)*
Auxiliary enterprises	$10,020	15% *(A)*
Total operating expenses	$66,740	100%

ties and provides the applicable percentages. Board members also should look at operating expenses over time.

5. **How dependent was the institution on investment or endowment income and annual giving to meet its operating needs?** This question focuses on two increasingly important revenue sources for many institutions: endowment income and fund-raising.
   - *Indicator A:* Private gifts and grants as well as investment income as a percentage of total operating revenues.

Factors to consider:

- Most institutions rely on external financial support to meet their operating budgets. It is important to understand the extent to which the institution depends on these revenue sources and whether they are sustainable.
- Private giving and investment (endowment) income also increase an institution's operating flexibility, enabling it to leverage other current fund revenue sources, especially tuition. Many institutions are becoming increasingly dependent on this revenue stream.

SanJo University Analysis

How dependent is SanJo University on the return on its endowment investments and annual giving to meet its operating needs? Approximately 12 percent of the university's total unrestricted operating revenues comes from private giving and investment income. A closer look at SanJo's Statement of Activities on page 28 indicates that private giving has increased, but investment income has declined. Clearly, SanJo University depends greatly on these other sources to meet operating expenses, and without them it would have incurred a substantial operating deficit.

Chart V-8 summarizes the relevant information from SanJo University's statement of activities and provides the applicable percentage for our analysis.

CHART V-8

DEPENDENCY ON GIFTS AND INVESTMENT INCOME

(For Question 5, Indicator A)

Revenue Source	1996 Total
Private gifts and grants	$4,084
Investment income	$4,110
Subtotal	$8,194
Total unrestricted operating revenues	$70,220
Percentage of total	12% *(A)*

6. **Do the auxiliary enterprises of the institution support their own costs?** Auxiliary enterprises traditionally include food services, housing, college stores, and other services. Ideally, for many institutions, these are self-supporting operations.
   - *Indicator A:* Auxiliary revenues less auxiliary expenses indicate an auxiliary operating surplus or deficit.

Factors to consider:

- Virtually all colleges and universities provide auxiliary services such as bookstores and food services. These activities need to be priced and operated so they do not financially drain the institution. Most institutions operate their auxiliaries near the break-even point on a fully costed basis. (That is, the direct and indirect current and long-term auxiliary costs are paid for through fees.) A few auxiliary enterprises are net resource providers, however.
- It is important to understand the operating results from auxiliary enterprises and the manner in which they are determined. In the past, not all institutions allocated fully to these enterprises the costs associated with operating them (including depreciation, for example). Now, more institutions are likely

to do so. For this reason, the statement of activities should reflect the actual results.

- Outsourcing is another consideration. Many institutions are choosing to outsource rather than self-manage certain areas of their operations. Areas unrelated to the institution's mission are the most likely candidates for outsourcing. Other likely areas are those in which the institution is not able to break even. An external vendor who specializes in the area (such as food services) may be able to operate it more profitably and improve quality as well.

SanJo University Analysis

Are SanJo University's auxiliary enterprises supporting their own costs? In fiscal 1996, SanJo University produced an auxiliary operating surplus of $2,079. This surplus enabled the university to augment certain programs in service to the overall mission of the university. We do not know, however, whether the university fully allocates the actual costs associated with operating its auxiliary services to the reported line item.

Chart V-9 summarizes the relevant information for our analysis from the university's statement of activities and presents the institution's auxiliary surplus of $2,079.

7. How well did the institution manage its investments? An important function of the governing board is to ensure that the institution's endowments and other funds are invested to produce stated objectives. The board regularly should monitor the rate of return on investments. With the adoption of the SFAS No. 124, "Accounting for Certain Investments Held by Not-for-Profit Organizations," the amount and type of data about an institution's investments presented in the statement of activities and the accompanying footnotes should enable board members and other readers of the institution's financial statements to determine how well the institution has done.

- *Indicator A:* Interest income and dividends plus net realized and unrealized gains less related management and custodial expenses as a percent of average market value.

Factors to consider:

- Investment income reflects the size of an institution's portfolio as well as earnings on its investments.
- An imbalance among the rates of investment income, spending, and reinvestment can result in an erosion of the future purchasing power of the institution's portfolio. (Growth must be greater than inflation and use.)
- Board members need to look at total return on investments, which includes interest income and dividends as well as net realized and unrealized gains.
- A board also may adopt a spending policy that permits the use of the yield (dividends and interest) as well as a prudent portion of the portfolio gains.

SanJo University Analysis

How well did SanJo University manage its investments in fiscal 1996? All of the requisite information for this question is included in the "Investments" footnote to SanJo's financial statements. We have summarized this information in Chart V-10 on the next page. As you can see, the university's total return was 10.1 percent.

8. How well did the institution manage its fund-raising? Because the various formats report gifts in different places in the statement of activities, the level of charitable giv-

CHART V-9

AUXILIARY ENTERPRISES

(For Question 6, Indicator A)

Sales & service revenue	$12,099
Expenses	$10,020
Net auxiliary services revenue	$ 2,079 *(A)*

CHART V-10

INVESTMENT PERFORMANCE

(For Question 7, Indicator A)

	1996
Return net of investment expense:	
Interest income and dividends	$9,053
Realized and unrealized gains, net (13,198 + 2,647)	$15,845
Total (B)	$24,898
Beginning market value*	$240,743
Ending market value*	$249,152
Average market value (C)	$244,948
Total return on investments (B/C)	10.1% *(A)*

*From footnote 4 of Appendix A.

ing may not always be readily apparent. Some institutions are summarizing fund-raising data in their footnotes to simplify and enhance the reader's understanding. With the adoption of SFAS No. 116, "Accounting for Contributions Received and Contributions Made," unconditional pledges are recorded as contributions when the donor makes the commitment and are reflected in the financial statements at the present value of the amounts the institution expects to receive. As a result, the amounts reflected in the statement of activities as "gifts" or "contributions" generally will not be the amount of cash the institution actually receives from donors during the period. (The statement of cash flows discussed in Chapter 6 of this book will clarify the level of cash contributions that were actually received during the year.)

On the other hand, the statement of activities measures contributions on the accrual basis, which should help readers assess an institution's overall fund-raising activities for the year. Also, the FASB requires the institution to disclose the cost of fund-raising either in the statement of activities or in the footnotes to the financial statements.

The practices of many development offices differ from the standards the FASB established for recognition of a contribution. As a result, the data the development office reports usually will differ from that reported in the financial statements. The most common differences relate to conditional gifts or bequests, which are not recognized for accounting purposes until they become unconditional gifts.

• *Indicator A:* Fund-raising costs as a percent of gifts recorded.

Factors to consider:

• It is important to understand why giving fluctuates from year to year. Annual giving usually will increase as the number and percent of alumni giving increases. Capital giving generally will fluctuate, especially if the institution is in the midst of a capital campaign.

- Charitable giving decreases an institution's reliance on tuition and other revenue sources as well as its need for external financing for capital projects.
- Charitable giving may be subject to volatility when tax regulations are revised or in times of financial uncertainty or recession.
- An institution may want to compare its charitable-giving trends to those of peer institutions. Also, rating agencies often consider the percentage of alumni (and sometimes the average gift per alumni) who give to their alma mater as an indicator of their satisfaction with the institution.
- Development frequently is perceived as an expensive department. Many development departments are trying to control costs. Fund-raising costs as a percentage of gifts recorded is an important indicator.

CHART V-11

FUND-RAISING DATA

(For Question 8, Indicator A)

Statement of Activities	1996	1995
Private gifts and grants	$6,723	$5,647
Capital gifts	6,820	8,511
Total gifts recorded	$13,543	$14,158
Fund-raising costs (data from footnote 2 in Appendix A)	$2,708	$2,531
Fund-raising costs as percent of gifts recorded	20%	18% *(A)*

Another important indicator is a summary of annual and capital campaign activity by source (from alumni, other individuals, foundations, corporations, and other sources). This information is not available from the financial statements.

SanJo University Analysis

How well did SanJo University manage its fund-raising activities in fiscal 1996? The data extracted from the SanJo University statement of activities and presented in Chart V-11 should help demonstrate how to measure the cost portion of this data. (Please note that the fund-raising costs in Chart V-11 are disclosed in the "Contributions" footnote to the financial statements. The complete financial statements of SanJo University, including the footnotes, are included in Appendix A.)

As you can see from Chart V-11, the university's fund-raising costs as a percentage of gifts recorded was 20 percent in 1996, compared with 18 percent in 1995. The university will need to gather information and summarize it for board members about the level of its alumni, corporate, and foundation giving for fiscal 1996.

SUMMARY

The foregoing are the most basic questions the statement of activities and the related footnotes address. Board members who want a fuller understanding of the operating and related results must ask many other questions and ask for a far more detailed analysis. Lenders, rating agencies, and the institution's own administrators use other methods to perform such assessments. Chapter 7 explains some of these measures in greater detail.

STATEMENT OF ACTIVITIES: COMMONLY USED FORMATS

Format 1—Simple Nonsegregated Format

This format (see Chart V-1) summarizes the relevant changes within each of the net assets groups without distinguishing between operating and nonoperating activity of the unrestricted net assets. It is difficult to find important information about fund-raising and investment performance because many of the information categories are repeated within each of the net asset categories. This format also makes it difficult to determine how well the institution is performing financially except on a very aggregated basis. In short, it may raise more questions than it answers.

Format 2—"Stacked" Operating Measure Format

This format (see Chart V-2) segregates operating activities from nonoperating activities within the unrestricted net assets. It clearly displays a "measure of operations"—namely, the excess (or deficiency) of operating revenues compared with operating expenses. The reader

CHART V-1

Sample University #1
Statement of Activities
Year ended June 30, 19xx

	Unrestricted	Temporarily Restricted	Permanently Restricted	19xx Total
REVENUES				
Tuition and fees, net	xxx			xxx
Government grants	xxx	xxx		xxx
Private gifts	xxx	xxx	xxx	xxx
Endowment income	xxx			xxx
Auxiliary enterprises	xxx			xxx
Other	xxx			xxx
Reclassifications	xxx	(xxx)		
TOTAL REVENUES	xxx	xxx	xxx	xxx
EXPENSES:				
Instruction	xxx			xxx
Academic support	xxx			xxx
Institutional support	xxx			xxx
Auxiliary enterprises	xxx			xxx
TOTAL EXPENSES	xxx			xxx
Change in net assets	xxx	xxx	xxx	xxx
Net assets at beginning of year	xxx	xxx	xxx	xxx
Net assets at end of year	xxx	xxx	xxx	xxx

CHART V-2

ANALYZING THE STATEMENT OF ACTIVITIES: STACKED OPERATING MEASURE FORMAT

Sample University #2
Statement of Activities
Year ended June 30, 19xx

Unrestricted Operating Revenues:	
Tuition and fees, net	xxx
Government grants	xxx
Private gifts	xxx
Endowment income	xxx
Auxiliary enterprises	xxx
Other	xxx
Reclassifications	xxx
Total Unrestricted Operating Revenues	xxx
Operating Expenses:	
Instruction	xxx
Academic support	xxx
Institutional support	xxx
Auxiliary enterprises	xxx
Total Unrestricted Operating Expenses	xxx
Increase in unrestricted net assets from operations	xxx
Increase in unrestricted net assets from nonoperating activity	xxx
Increase in unrestricted net assets	xxx
Increase in temporarily restricted net assets	xxx
Increase in permanently restricted net assets	xxx
Increase in net assets	xxx
Net assets at beginning of year	xxx
Net assets at end of year	xxx

readily can see which of the unrestricted net asset changes (contributions and investing activities, for example) the institution considers to be nonoperating activities because they represent reinvestment or deferral for some designated future use. It is still difficult to find important information about fund-raising and investment performance because the information is spread among the three net asset categories.

Format 3—Columnar Operating Measure Format

This format (see Chart V-3) is among the most popular formats used by colleges and universities. It not only distinguishes between the operating and nonoperating activity of the unrestricted net assets, but it also simplifies and consolidates the presentation of information about fund-raising and investment performance as well as the degree to which the institution reinvests such income or uses it to support operations. The case study of SanJo University focuses, in part, on the analysis of its statement of activities, which has been prepared essentially in the columnar operating measure format.

CHART V-3

ANALYZING THE STATEMENT OF ACTIVITIES: COLUMNAR OPERATING MEASURE FORMAT

Sample University #3
Statement of Activities
Year ended June 30, 19xx

	Temporarily Unrestricted	Permanently Restricted	19xx Restricted	Total
OPERATING REVENUES:				
Tuition and fees, net	xxx			xxx
Government grants	xxx			xxx
Private gifts	xxx	xxx		xxx
Endowment income	xxx	xxx	xxx	xxx
Auxiliary enterprises	xxx			xxx
Other	xxx			xxx
Reclassifications	xxx	(xxx)		xxx
Total operating revenues	xxx	xxx	xxx	xxx
OPERATING EXPENSES:				
Instruction	xxx			xxx
Academic support	xxx			xxx
Institutional support	xxx			xxx
Auxiliary enterprises	xxx			xxx
Total operating expenses	xxx			xxx
Increase in net assets from operating activities	xxx			xxx
NONOPERATING ACTIVITIES				
Realized and unrealized investment gains	xxx	xxx	xxx	xxx
Pledges	xxx	xxx	xxx	xxx
Other	xxx	xxx	xxx	xxx
Increase in net assets from nonoperating activities	xxx	xxx	xxx	xxx
Net increase in net assets	xxx	xxx	xxx	xxx
Net assets at beginning of year	xxx	xxx	xxx	xxx
Net assets at end of year	xxx	xxx	xxx	xxx

6

STATEMENT OF CASH FLOWS

The statement of cash flows provides information about an institution's cash receipts and payments during a specific period. A statement of cash flows has been required for corporate entities for many years under SFAS No. 95, "Statement of Cash Flows," but not until adoption of SFAS No. 117 has it been required for colleges and universities. The requirements for higher education institutions are very similar to those for commercial enterprises.[1] The cash flow statement must present separately the following activities:

- Cash flows from *operating* activities.
- Cash flows from *investing* activities.
- Cash flows from *financing* activities.

The starting point for determining cash flows from operations for a college or university is the total change in net assets. Effectively, changes that neither provide nor consume cash must be removed from the change in net assets. For example, gifts in kind do not provide cash, and depreciation does not consume cash.

In addition, items that increase net assets but are long term in nature must be removed from cash flows from operating activities. For example, contributions for long-term investment—whether in the form of new funds for endowment or funds to be expended for the acquisition or construction of property, plant, or equipment—are considered long-term increases to net assets. Accordingly, they must be removed from operations and reclassified to financing and/or investing activities.

The third category of changes that affect cash flows from operating activities are the changes in an institution's working capital (that is, its current assets and liabilities). For example, if accounts receivable increase, the institution's working capital decreases. Conversely, if accounts receivable decrease, the institution's working capital increases.

The second section of the statement of cash flows deals with investing activities. For the typical college or university, investing activities often constitute purchases or sales of plant, equipment, and investments.

Finally, the last category of cash flows is from financing activities. Typical financing activities include the issuance of long-term debt and the repayment of debt. A moment ago, we mentioned that contributions for long-term investment are removed from the total changes in net assets because they do not affect cash flows from the institution's operating activities. However, contributions for long-term investment affect the institution's *financial position*, and are considered to be financing activities in the statement of cash flows.

Overall, the sum of the three components of changes in cash flow activities equals the total

[1] The cash flows from operating activities for all kinds of enterprises can be reported under either the so-called "direct" or "indirect method." If institutional officials choose the direct method, each revenue and expense appears as a separate line item that reflects the amount of cash that operations of the enterprise provided or consumed. Few, if any, colleges and universities have adopted this format. Although it is very informative, it is difficult to prepare. The other method is the so-called "indirect method," which in effect reconciles the changes in net assets for the institution as a whole with the amount reflected as the cash flow used for or provided by operations.

The statement of cash flows provides valuable information about the institution that it previously did not have to provide. In fact, many users of the old fund-accounting formatted financial statements looked to the statement of changes in fund balances as if it were a funds flow statement of sorts. In fact, it was not. The result was confusion for the reader. The statement of cash flows more precisely delineates the major cash flow activities of each institution.

change in the cash and cash equivalents that have been reported in the statement of financial position. Cash and cash equivalents, as defined by SFAS No. 95, include all cash and some deposits as well as short-term investments with a maturity of not more than 90 days at the time of purchase.

STATEMENT OF CASH FLOWS FOR SANJO UNIVERSITY: A WALK THROUGH

Exhibit C presents the statement of cash flows for SanJo University for fiscal 1996 (and for fiscal 1995 for purposes of comparison). The four major categories (indicated in bold type in Exhibit C) are Cash Flows from Operating Activities, Cash Flows from Investing Activities, Cash Flows from Financing Activities, and Supplemental Data.

You will see that the statement of cash flows in Exhibit C begins with the change in net assets of $23,850 from the university's statement of activities in Exhibit B. Looking down the column of 1996 totals, the net cash provided by operating activities after the adjustments for fiscal 1996 is $6,749 (a surplus). The net cash used in investing activities (purchases of plant, equipment, and investments, as well as proceeds from the sales and maturities of investments) is $12,278. In fiscal 1996, SanJo used more cash for investing activities than it took in. The net cash provided by financing activities is $4,745 (another surplus). Finally, cash and cash equivalents at the end of the year is $14,866, which corresponds to the number for cash and cash equivalents on the statement of financial position in Exhibit A.

SanJo University also has presented supplemental data on the face of its statement of cash flows. Noncash investing and financing activities (gifts in kind) total $412 in fiscal 1996, and interest paid totals $2,952 in fiscal 1996.

ANALYZING THE STATEMENT OF CASH FLOWS

The information provided by the cash flow statement enables the reader to readily determine how the institution finances plant expansion, how it reinvests in its future, and whether there is operating cash available for such important commitments as deferred-maintenance programs and servicing debt. According to the FASB, the cash flow statement should help users to "(a) assess the enterprise's ability to generate positive future net cash flows, (b) assess the enterprise's ability to meet its obligations...and its needs for external financing, (c) assess the reasons for differences between net income and associated cash receipts and payments, and (d) assess the effects on an enterprise's financial position of both its cash and noncash investing and financing transactions during the period." (SFAS No. 95, par. 5) Note that SFAS No. 117 amended SFAS No. 95 to note that the term "net income" applies to business enterprises, and the term "changes in net assets" applies to nonprofit organizations.

The statement of cash flows answers the strategic question: *What are the institution's sources of cash, and how has it used them for operations, investing, and financing activities?* The total changes in operating activities, investing activities, and financing activities for the year provide relatively simple indicators for this question. Chart VI-1 summarizes this information for SanJo University

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EXHIBIT C

STATEMENT OF CASH FLOWS

SanJo University
Statement of Cash Flows
For the years ended June 30, 1996 and 1995 (in thousands)

Cash Flows From Operating Activities	**1996**	**1995**
Change in net assets	$23,850	$22,510
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Depreciation and amortization	4,684	3,866
Gains on investments	(15,845)	(2,756)
Gain on equipment disposals	(99)	(63)
Capital gifts	(5,886)	(7,151)
Other nonoperating activity	1,698	257
Changes in assets and liabilities that provide (use) cash:		
Accounts receivable	(159)	(71)
Pledges receivable	(48)	(15,285)
Student loans receivable	48	46
Short-term investments	(666)	(221)
Inventories	(47)	(56)
Prepaid expenses and other assets	65	(74)
Accounts payable and accrued expenses	(1,285)	1,594
Deposits and deferred revenues	138	165
Postretirement benefits	283	6,029
Other changes	18	(1,478)
Net cash provided by operating activities	6,749	7,312
Cash Flows From Investing Activities		
Purchases of plant and equipment, net	(18,016)	(18,909)
Purchases of investments	(265,934)	(337,735)
Proceeds from sales and maturities of investments	273,370	336,969
Other nonoperating activity	(1,698)	(257)
Net cash used in investing activities	(12,278)	(19,932)
Cash Flows From Financing Activities		
Proceeds from contributions for:		
Investment in endowment	3,965	4,851
Investment in long-lived assets	1,921	2,300
Proceeds from issuance of long-term debt		
Payments on long-term debt	(1,141)	(1,068)
Net cash provided by financing activities	4,745	6,083
Net decrease in cash and cash equivalents	(784)	(6,537)
Cash and cash equivalents, beginning of year	15,650	22,187
Cash and cash equivalents, end of year	$14,866	$15,650
Supplemental Data		
Noncash investing and financing activities—gifts in kind	$412	$580
Interest paid	$2,952	$2,114

The accompanying notes are an integral part of the financial statements.

from its statement of cash flows.

Ratio analysis also can help determine answers to questions about an institution's cash flows. Such ratios include the operating cash flow to debt service ratio, which measures the ability of an institution to meet its debt service from its operating cash flows. While this chapter has focused on a basic understanding of the statement of cash flows, Chapter 7 provides several ratios to assess liquidity.

CHART VI-1

1996 CASH FLOWS FOR SANJO UNIVERSITY

Cash Flow Category	1996 Total	Factors Affecting 1996 Total
Net cash provided by operating activities	$6,749	The result of a number of reconciliation items.
Net cash used in investing activities	($12,278)	The result of purchasing more investments, property, and equipment than was sold.
Net cash provided by financing	$4,745	The result of proceeds from contributions for investments in endowment, primarily, decreased slightly by payments on long-term debt.

7

EXTERNAL MARKET ASSESSMENTS

Keep in mind that the FASB's objective is to bring the financial reporting of nonprofits more in line with that of the for-profit world and that the major objective of financial reports is to meet the diverse information needs of various internal and external users. Consequently, because colleges and universities accept funds from donors, foundations, and other external sources, they must understand the information needs of these users when preparing external financial reports.

Many questions these users ask are similar to those of external users of for-profit statements. Lenders want to know whether they will be paid back. Donors and foundations want to know that the institution will use the donated funds in an effective manner. By publishing comparative ratios or other measures and by providing information on operating results, cash flows, liquidity, and the financial viability of the institution, a college or university can help answer such questions. While the ratios may differ slightly from those found in for-profit organizations, the underlying questions they address are similar.

Rating agencies such as Moody's Investors Service and Standard & Poor's have redefined the ratios used to measure constructs such as liquidity and financial viability after the implementation of SFAS Nos. 116 and 117. Each stated that the overall bond ratings of colleges and universities should not change, because financial statements under SFAS Nos. 116 and 117 do not change an institution's financial condition—just how its financial information is displayed. Consequently, the concepts measured by the ratios have not changed, but the information underlying them now appears in different places in the new financial statements. In addition, these financial statements contain new information (the cash flow statement, for example) that can be evaluated using some previously unavailable ratios.

Moody's views higher education as a business enterprise. Although the notion of applying management terms to nonprofit organizations may seem relatively new, all organizations use financial and human resources, regardless of their mission. As a result, they must have information systems in place to report on the use of their resources. As business enterprises, they must be concerned with the demand for their service, how to "price" it, and what is their market niche. For nonprofit organizations, service, price, and market niche relate to an institution's mission and the strategy necessary to carry it out.

Moody's looks at five key areas in assessing the financial viability of an organization:

- Market position. Student demand translates into revenue streams.
- Financial performance. Is the institution financially sound?
- Debt position. The indicator examines the role of debt in the capital structure of the organization as well as issues surrounding deferred maintenance.
- Legal structure. How is the debt of the organization secured?

- Management. Does the management team have a credible financial and market strategy, and has it shown it can execute that strategy?

These five areas illustrate that financial statements and the comparative financial ratios that attempt to measure them are only part of the assessment of a higher education institution. Governmental, economic, and demographic influences on the environment in which the institution operates affect its financial health. The internal factors Moody's evaluates include statistics concerning students, faculty, capital, finances, and management.

Standard & Poor's bases its assessment of a higher education institution on many of the same external and internal factors. Following are some key nonfinancial information S&P has identified:

- Admissions flexibility.
- Geographic diversity of the student body.
- Student quality.
- Quality, number, and tenure status of the faculty.
- Program offerings.
- Competition.
- Management strategies.

These factors also emphasize the qualitative factors that bring the numbers to life. Accordingly, like Moody's, S&P meets with management in an effort to look behind the numbers and determine management's strategy.

Board members need to be aware of the external financial markets and rating agencies and the assessments these agencies conduct of an institution's financial health. Such assessments are especially important when an institution is seeking additional funds—for financing, foundation funding, or capital campaigns, for example. Equally important, however, are self-assessments of an institution's financial health. Ratios and other measures can help boards and management monitor an institution's operating results, liquidity, and financial strength.

The federal government is adopting standards of financial responsibility for institutions participating in student financial-assistance programs under Title IV. These ratios also provide a measure of an institution's financial health. The focus is on the ability of the institution to meet debt obligations, the level of reserves available to support current operations, as well as the ability of an institution to live within its means in a given operating cycle. The federal standards are similar to the financial constructs captured by the ratios that follow.

The next part of this chapter presents ratios—some of which also are used by external parties—for a self-assessment of an institution's health. It is divided into three sections: (1) operating ratios, (2) financial-strength ratios, and (3) cash-flow ratios.

1. OPERATING RATIOS

Operating ratios help determine whether an institution is living within its means. Over time, they also point to possibly significant changes in revenues and expenses. Information for operating ratios comes primarily from the statement of activities. The statement of activities and the ratios derived from it answer the strategic question: *How did the institution use its resources to provide service to its constituents?* The key ratios from the statement of activities include (1) operating revenue, (2) tuition discount, (3) net operating income, (4) expendable net assets, and (5) debt service.

Operating Revenue Ratio. This ratio captures the degree to which an institution relies on net tuition and fees to meet its operating expenses.

$$\frac{\text{Operating Revenue}}{\text{Educational \& General Expense}}$$

The higher the ratio, the more the institution is dependent on tuition and fees to meet its costs. This implies fewer alternative sources of revenue, such as income from endowment and research grants, are available. If this ratio is high, then it also is important to look at the se-

lectivity of the institution, including the number of applicants, the acceptance rate, the yield on acceptances, and such information as rank in high school class and SAT scores. (Admission information also is reviewed by the rating agencies, because high tuition dependency combined with less selectivity implies a riskier revenue position and hence potentially less cash for debt repayment.)

In the case of SanJo University, the ratio for 1996 is 78.54 percent, indicating a relatively high tuition dependency. The ratio also has been increasing slightly over the last three years implying that SanJo is becoming increasingly tuition dependent (see Table VII-1).

Tuition Discount Ratios. Tuition discounting is a critical issue for many colleges and universities. To become more competitive, these institutions have increased their financial-aid budgets—in some cases without determining the long-term implication of these increases. If the financial-aid budget increases at a rate in excess of the rate of tuition increases, it is only a matter of time before the institution will lack sufficient revenues to meet expenses.

Financial aid becomes especially critical when it is unfunded, in which case it is truly a "sales discount" off the price of tuition. If an institution uses endowment income and gifts and grants restricted to financial aid, then these resources can accommodate the lost revenue from discounting tuition to aid recipients. The

TABLE VII-1

OPERATING REVENUE RATIO

Measures dependency on operating revenue (principally net tuition and fees) to meet operating expenses.

		1996	1995	1994
OPERATING REVENUE / EDUCATIONAL & GENERAL EXPENSE	*(A/B)*	**78.54%**	**75.38%**	**76.83%**
Operating Revenue includes:				
1. Net Tuition		39,165	35,739	34,728
2. Auxiliary Enterprise Revenue		12,099	10,628	10,378
Less: Auxiliary Enterprise Expenses		(10,020)	(8,845)	(8,364)
3. Unrestricted Grants & Contracts		1,991	1,684	1,909
4. Other Unrestricted Income (excluding long-term investment income, gains used for operations, and contributions)		1,314	1,285	898
	(A)	**44,549**	**40,491**	**39,549**
Educational & General Expense includes:				
1. All operating expenses		66,740	62,563	59,841
2. Auxiliary operating expenses (netted vs. revenues in numerator)		(10,020)	(8,845)	(8,364)
	(B)	**56,720**	**53,718**	**51,477**

Note: Debt service and depreciation are included functionally in operating expenses. See Table VIII-5.

Audit and Accounting Guide, Not-for-Profit Organizations (published by the American Institute of Certified Public Accountants in 1996) requires that colleges and universities show tuition revenue net of any institutional aid. Such information is needed to calculate two ratios that are important because they highlight the difference between all institutional financial aid and the unfunded portion of it. The first ratio indicates the total discounting that occurs through all institutional sources of aid.

Total Financial Aid
Tuition and Fees

The second ratio measures the total nonfunded institutional aid as a percent of tuition and fees. This ratio is a true measure of the institution's tuition discount, representing the portion of lost tuition and fees that is not being matched by other outside sources of revenue.

Nondonor-Supported Financial Aid
Tuition and Fees

For SanJo University, total institutional aid represents 27.87 percent of tuition and fees, which is in range of many similar institutions. However, only 9.48 percent represents aid that is not funded and hence is a "true" discount from tuition and fees. Approximately one-third of the institutional aid budget ($5.1 million out of $15.1 million) is not funded. Again, these percentages are increasing for SanJo University, a trend both the board and management should watch (see Table VII-2).

Net Operating Income Ratios. Net operating income ratios measure the surplus (or deficit) resulting from operations measured both with and without investment income and contributions. The first ratio excludes investment income and contributions and therefore looks at the degree to which the institution operates on a

TABLE VII-2

TUITION DISCOUNT RATIOS

Measures percentage of donor-supported financial aid and the portion that is effectively an institutional discount aimed at achieving enrollment objectives.

		1996	1995	1994
a. TOTAL FINANCIAL AID / TUITION AND FEES	(B/C)	27.87%	27.18%	24.96%
b. NONDONOR-SUPPORTED FINANCIAL AID / TUITION AND FEES	(A/C)	9.48%	9.06%	8.32%
a. Financial Aid includes all aid from all sources provided by the institution.				
University-sponsored financial aid				
Donor-sponsored financial aid		9,988	8,892	7,702
Total Financial Aid	(B)	15,133	13,338	11,554
Tuition and Fees	(C)	54,298	49,077	46,282

b. Nondonor-supported financial aid includes all aid provided by the institution from its operating budget other than donor funds or true endowment income for scholarships.

break-even basis from exchange-type transactions—for example, do tuition and fees cover operating expenses? Keep in mind that few institutions are capable of meeting all their operating expenses from tuition, fees, and other "sales type" revenues. Since budgets are tied to operating results, it is worth looking at the budget to see what "spending rate" the institution used to determine how much investment income and contributions it would need to meet operating expenses. If the institution uses a figure in excess of the budgeted spending rate and available contributions, this could indicate either that tuition revenues were insufficient to meet operating expenses or expenses exceeded expectations. Here is the first net operating income ratio:

$$\frac{\textbf{Net Operating Surplus (Deficit) Without Investment Income and Contributions}}{\textbf{Total Operating Revenue}}$$

The second net operating income ratio, which follows, includes all income designated as operating income, including the amounts spent under the institution's "spending policy" and other contributions that were available for operating purposes.

$$\frac{\textbf{Net Operating Income (Deficit)}}{\textbf{Total Operating Revenue}}$$

The net operating income ratios for SanJo University have improved over the past three years. The 1996 surplus is 4.96 percent of total operating revenues. This implies that the university's revenue is increasing faster than its expenses because of higher tuition charges or greater enrollment or that the university has been successful at controlling its costs. (Financial statement readers also may want to consider whether the institution's policy on its endowment spending rate has changed.) It also is noteworthy that SanJo University has achieved a modest operating surplus in each of the last three years (see Table VII-3).

Expendable Net Assets Ratios. These ratios measure the net assets available for expenditures, including operating expenses and any required repayment of debt principal. Expendable net assets typically include unrestricted net assets (other than net investment in plant) plus temporarily restricted net assets available to meet future operating expenses. The first expendable net assets ratio follows:

$$\frac{\textbf{Unrestricted Net Assets Less Net Investment in Plant}}{\textbf{Total Operating Expenses Plus Debt Service Principal}}$$

This ratio is more conservative because it only considers unrestricted net assets that are available for operating purposes.

Here is the second expendable net assets ratio:

$$\frac{\textbf{Expendable Net Assets Less Net Investment in Plant}}{\textbf{Total Operating Expenses Plus Debt Service Principal}}$$

This ratio also considers temporarily restricted net assets that may be available to meet future operating costs. A number greater than one indicates an institution has sufficient resources to meet one year's expenses and debt repayment even if it earns no future revenue. These ratios measure an institution's financial flexibility in the event of a decline in revenues.

For SanJo University, both of these ratios have been declining over the past three years, to 142 percent for the first ratio and 294 percent for the second. This indicates the university has fewer net assets available to cover operating expenses and that the increase in its expendable net assets has not kept pace with the increase in its expenses. However, the ratio levels currently are more than adequate, demonstrating reasonable strength if the university suffered a decline in its operating income (see Table VII-4).

TABLE VII-3

NET OPERATING INCOME RATIO

Measures return on revenues (sales)

		1996	1995	1994
a. Excluding Investment Income & Contributions				
NET OPERATING SURPLUS (DEFICIT) WITHOUT INVESTMENT INCOME AND CONTRIBUTIONS / TOTAL OPERATING REVENUE	*(A/C)*	**–17.33%**	**–20.51%**	**–19.32%**
Net operating income (deficit) excluding income from donor-restricted investments (e.g., endowment income) and contributions. Basically all operating income from exchange type transactions divided by the net income from such transactions:				
1. Increase in unrestricted net assets from operations	*(B)*	3,480	1,933	1,904
2. Less:				
Long-term investment income		(4,110)	(5,120)	(5,463)
Investment gains used for operations		(1,191)	(433)	
Unrestricted private gifts and grants		(4,084)	(3,875)	(3,566)
Temporarily restricted net assets released from restrictions		(6,266)	(5,732)	(4,803)
	(A)	(12,171)	(13,227)	(11,928)
b. Reported Net Operating Income				
NET OPERATING INCOME (DEFICIT) / TOTAL OPERATING REVENUE	*(B/C)*	**4.96%**	**3.00%**	**3.08%**
Operating revenues	*(C)*	70,220	64,496	61,745

Debt Service Ratios. An institution can use these ratios to gauge its ability to meet its debt obligations. The ratios focus on interest expense taken from the statement of activities and principal repayment taken from the cash flow statement.

The debt service to operating expenses ratio measures the percentage of debt service to the total operating costs of the institution, including required principal payments on outstanding debt. This ratio is a relative measure of the effect of debt service on the overall cost of operations. As this percentage climbs higher, an institution will have to spend more on debt service than on its other operating needs. A high percentage also indicates the institution has less financial flexibility if its operating or economic conditions were to change. (Ideally, it is wise to keep the debt service ratio in the 5 percent to 10 percent range.) SanJo has seen this percentage increase from 5 percent to 6.03 percent over the last year.

TABLE VII-4

EXPENDABLE NET ASSETS RATIOS

Measures unrestricted resources available against one year's operating costs plus the principal portion of the debt service.

		1996	1995	1994
a. **UNRESTRICTED NET ASSETS LESS NET INVESTMENT IN PLANT / TOTAL OPERATING EXPENSES PLUS DEBT SERVICE PRINCIPAL**	*(A/B)*	**142%**	**158%**	**185%**
Unrestricted net assets		157,212	147,342	143,459
Less: Investment in plant		(61,047)	(46,491)	(29,796)
	(A)	96,165	100,851	113,663
Total Operating Expenses		66,740	62,563	59,841
Debt Service Principal (from Cash Flow Statement or Debt footnote)		1,141	1,068	1,468
	(B)	67,881	63,631	61,309
b. **EXPENDABLE NET ASSETS LESS NET INVESTMENT IN PLANT / TOTAL OPERATING EXPENSES PLUS DEBT SERVICE PRINCIPAL**	*(C/B)*	**294%**	**305%**	**332%**

Measures all resources available for expenditure against one year's operating costs plus the principal portion of the debt service.

Unrestricted net assets		157,212	147,342	143,459
Temporarily restricted net assets		103,537	93,522	89,894
Less: Investment in plant *(from Appendix A, footnote 7)*		(61,047)	(46,491)	(29,796)
	(C)	199,702	194,373	203,557

Annual Debt Service (Interest Expense + Principal Repayment) / Operating Expenses Plus Debt Principal Repayment

(Principal repayment includes only the normal required amortization of debt. It should not include prepayments or refinancings.)

Another ratio is the debt service coverage ratio, which measures the ability of the institution to meet debt service obligations from operating resources. This ratio looks at the operating surplus plus interest expense as a percentage of annual debt service. A number greater than one (that is, 100 percent) indicates the institution is able to meet its debt obligations from current operating resources.

Operating Surplus Plus Interest Expense / Annual Debt Service

The debt service coverage ratios have improved for SanJo University, increasing to 157 percent in 1996. While the debt service to operating expenses ratio has increased to 6.03 per-

cent, the overall debt service coverage ratio remains safely above the 100 percent minimum threshold (see Table VII-5).

2. FINANCIAL STRENGTH RATIOS

Financial strength ratios measure the long-term viability of a college or university by focusing on its debt and endowment. Information for financial strength ratios comes primarily from the statement of financial position. The statement of financial position and related ratios provide information about the solvency, financial flexibility, and long-term financial viability of an institution. The greater an institution's endowment and the lower its debt, the more flexibility an institution has to address changes that affect its revenue and expense streams. The statement of financial position and related ratios answer the strategic question: *Are existing resources sufficient to enable the institution to fulfill its mission?*

TABLE VII-5

DEBT SERVICE RATIOS

a. Debt Service to Operating Expenses

Measures the percentage of debt service to the total operating costs of the institution.

		1996	1995	1994
ANNUAL DEBT SERVICE / OPERATING EXPENSES PLUS DEBT SERVICE PRINCIPAL	*(A/B)*	**6.03%**	**5.00%**	**5.75%**
Interest expense (from Cash Flow Statement or footnotes)		2,952	2,114	2,059
Required principal payments on debt (from Cash Flow Statement or footnotes)		1,141	1,068	1,468
	(A)	4,093	3,182	3,527
Total Operating Expenses		66,740	62,563	59,841
Debt Service Principal (from Cash Flow Statement or Debt footnote)		1,141	1,068	1,468
	(B)	67,881	63,631	61,309

b. Debt Service Coverage Ratio

Measures the ability of the institution to meet debt service obligations from normal operating sources.

OPERATING SURPLUS PLUS INTEREST EXPENSE / ANNUAL DEBT SERVICE	*(C/A)*	**157%**	**127%**	**112%**
Increase in Unrestricted Net Assets		3,480	1,933	1,904
Interest expense (from Cash Flow Statement or footnotes)		2,952	2,114	2,059
Operating Surplus Plus Interest Expense	*(C)*	6,432	4,047	3,963

Financial strength ratios include the following:

- endowment to operating expenses,
- quasi-endowment to total endowment,
- endowment per FTE student,
- total debt to expendable unrestricted net assets,
- total debt to expendable net assets,
- increase in net assets, and
- total return on long-term investments.

Endowment to Operating Expenses Ratios. These ratios measure an institution's total endowment relative to its operating expenses. As this ratio increases, an institution has a greater degree of financial flexibility. That is, it has the ability to tap its endowment to meet operating costs if its operating revenues decline. The first endowment to operating expenses ratio is:

$$\frac{\text{Total Endowment (True and Quasi-Endowment)}}{\text{Total Operating Expenses}}$$

The second endowment to operating expenses ratio, which follows, eliminates pledges and represents actual dollars the institution has in hand:

$$\frac{\text{Total Endowment (True and Quasi) Without Pledges}}{\text{Total Operating Expenses}}$$

These two ratios have been above 300 percent and have remained fairly constant for SanJo University for the past two years. The institution has an endowment greater than three times the size of its annual operating expenses; this is considered to be a fairly strong position (see Table VII-6).

Quasi-Endowment to Total Endowment Ratio. This ratio measures the unrestricted portion of an institution's endowment. An institution's true endowment, in contrast to its quasi-endowment, is restricted by the donor and therefore is not readily available for the institution's use. The quasi-endowment to total endowment ra-

TABLE VII-6

ENDOWMENT RATIO

Measures the total endowment relative to the operating budget/costs of the institution.

			1996	1995
a.	TOTAL ENDOWMENT (TRUE & QUASI-ENDOWMENT) / TOTAL OPERATING EXPENSES	(B/C)	341%	329%
b.	TOTAL ENDOWMENT (TRUE & QUASI) WITHOUT PLEDGES / TOTAL OPERATING EXPENSES	(A/C)	326%	313%
	Funds Functioning as Endowment	(D)	86,269	85,807
	Accumulated Gains on Restricted Endowment		60,476	43,637
	Endowment and Similar Funds		70,517	66,570
	Endowment and Similar Funds Invested	(A)	217,262	196,014
	Pledges Receivable for Endowment		10,147	10,129
	Total Endowment	(B)	227,409	206,143
	Total Operating Expenses *(from Appendix A, footnote 7)*	(C)	66,740	62,563

tio represents the percentage of endowment a college or university can use at its discretion to meet its operating expenses. It is another indication of an institution's financial flexibility. The higher the ratio, the more unrestricted "endowment" dollars an institution controls.

$$\frac{\text{Quasi-Endowment}}{\text{Total Endowment (True and Quasi-Endowment)}}$$

SanJo University's quasi-endowment has decreased. In SanJo's case, this is because its true endowment has increased at a greater rate than its quasi-endowment. There is really no absolute measure for this ratio. Like most of these ratios, this ratio should be used in conjunction with other measures of financial strength to obtain a more complete financial picture of the institution (see Table VII-7).

Endowment Per FTE Student. The endowment per full-time-equivalent (FTE) student ratio measures the size of an institution's endowment relative to its enrollment. The higher the ratio, the more flexibility an institution has to meet rising costs and provide high-quality programs without increasing tuition. Without a significant endowment, an institution's only recourse is to increase its tuition and fees.

$$\frac{\text{Total Endowment (True and Quasi-Endowment)}}{\text{Number of FTE Students}}$$

The endowment per FTE student has risen this year for SanJo from $73,623 to $79,793. Considering the size of the institution (approximately 2,850 FTE students), the level of endowment is relatively high compared with that of similar institutions (see Table VII-8).

Total Debt to Expendable Unrestricted Net Assets. This ratio considers total outstanding debt relative to an institution's unrestricted net assets less net investment in plant. It measures the ability of an institution to meet its outstanding debt solely from unrestricted net assets. (It is similar to a debt to liquid equity ratio for a corporate enterprise.)

TABLE VII-7

QUASI-ENDOWMENT RATIO TO TOTAL ENDOWMENT

Measures the portion of endowment that is unrestricted.

QUASI-ENDOWMENT / TOTAL ENDOWMENT (TRUE & QUASI-ENDOWMENT)		1996	1995
	(D/B)	37.94%	41.62%

TABLE VII-8

ENDOWMENT PER FTE STUDENT

Measures the size of the endowment relative to enrollment.

TOTAL ENDOWMENT (TRUE & QUASI-ENDOWMENT) / NUMBER OF FULL-TIME EQUIVALENT STUDENTS		1996	1995
	(B/FTEs)	$79,793	$73,623
Number of full-time equivalent students		2,850	2,800

(Information from these tables comes from Table VII-6.)

Total Debt Outstanding
Unrestricted Net Assets
Less Net Investment in Plant

Recently, many institutions have found it more beneficial to borrow through tax-exempt offerings than to use unrestricted net assets that might earn higher returns through investments. In general, however, an institution with a high ratio of debt to expendable unrestricted net assets will be more highly leveraged and have less flexibility to continue to borrow. Note that the denominator for this ratio excludes plant assets, because these are not liquid. As a result, this is a particularly conservative measure of debt to equity.

The ratio of SanJo University's total debt to expendable unrestricted net assets has increased slightly from 49.30 percent to 50.52 percent. Ideally, an institution would want to maintain this ratio at 50 percent or below (see Table VII-9a).

Total Debt-to-Expendable Net Assets Ratio. More useful is the ratio that measures the relationship of outstanding debt to all expendable net assets. Like the foregoing ratio, it includes all unrestricted net assets (less net investment in plant assets). In addition, however, it includes temporarily restricted net assets that are expected to be available to meet the institution's obligations, operating and otherwise. Generally, temporarily restricted net assets become available to the institution as the donor's restrictions are met or with the passage of time, so it is appropriate to consider these net assets as available to the institution in determining this ratio.

Total Debt Outstanding
Unrestricted & Temporarily Restricted
Net Assets Less Net Investment in Plant

With the inclusion of the temporarily restricted net assets, the total debt to expendable net assets ratio for SanJo University is 24.33 percent, a slight improvement from the 25.58 percent of the prior year. Generally a ratio lower than 50 percent would be considered good, and below 25 percent would be excellent. These ratios work in concert with the debt coverage and related ratios in measuring the capacity of the institution to handle its existing debt as well as taking on new debt (see Table VII-9b).

Increase in Net Assets Ratio. This ratio measures the growth in an institution's total equity. An increase indicates an institution is adding to its reserves (preferably to its endowment). The increase must be greater than inflation if an in-

TABLE VII-9a

TOTAL DEBT TO EXPENDABLE UNRESTRICTED NET ASSETS

Measures the ability of the institution to meet outstanding debt from unrestricted net assets.

TOTAL DEBT OUTSTANDING / UNRESTRICTED NET ASSETS LESS NET INVESTMENT IN PLANT		**1996**	**1995**
	(A/B)	**50.52%**	**49.30%**
Total debt outstanding	*(A)*	48,579	49,720
Unrestricted net assets		157,212	147,342
Less: Net investment in plant		(61,047)	(46,491)
	(B)	96,165	100,851

TABLE VII-9b

TOTAL DEBT TO EXPENDABLE NET ASSETS

Measures the ability of the institution to meet outstanding debt from net assets which ultimately may be expended.

TOTAL DEBT OUTSTANDING / UNRESTRICTED & TEMPORARILY RESTRICTED NET ASSETS LESS NET INVESTMENT IN PLANT		1996	1995
	(A/B)	24.33%	25.58%
Total Debt Outstanding	(A)	48,579	49,720
Temporarily Restricted Net Assets		103,537	93,522
Unrestricted Net Assets		157,212	147,342
Less: Net Investment in Plant		(61,047)	(46,491)
	(B)	199,702	194,373

stitution is to achieve real growth of its financial resources. Here is the increase in net assets ratio:

$$\frac{\text{Total Increase in Net Assets}}{\text{Total Net Assets Beginning Balance}}$$

This ratio for SanJo University has remained relatively stable at 7.51 percent—more than twice the rate of inflation as measured by the Consumer Price Index. Measurement of growth in net assets must be viewed in the context of the beginning level of net assets, including its endowment. Since SanJo has a large endowment, its growth of 7.51 percent is even more impressive (see Table VII-10).

Total Return on Long-Term Investments Ratio. This ratio measures the total return on an institution's investments, including investment income plus the realized and unrealized gains on the investment portfolio.

$$\frac{\text{Investment Income Plus Realized and Unrealized Gains}}{\text{Average Long-Term Investments for the Period}}$$

TABLE VII-10

INCREASE IN NET ASSETS

Measures the growth in the equity of the institution. Should be compared to an objective measure of inflation to determine if there is real equity growth.

TOTAL INCREASE IN NET ASSETS / TOTAL NET ASSETS BEGINNING BALANCE		1996	1995
	(A/B)	7.51%	7.63%
Total increase in net assets	(A)	23,850	22,510
Net assets at the beginning of the year	(B)	317,563	295,052

Most institutions' investment policies focus on long-term growth in their investments, particularly those of their endowments. At the same time, they must meet their needs for current operating income. To do so, boards of trustees have adopted spending policies that permit the use of the yield (dividends and interest) as well as a prudent portion of the portfolio gains. In many institutions, this translates into a spending formula that approximates from 4 percent to 6 percent of some moving average of the portfolio's fair-market value. If an institution is to achieve real long-term growth, then the total return on long-term investments must exceed both the spending formula and inflation.

For SanJo University, the 1996 results achieve real long-term growth that the university did not achieve in 1995, as is shown below:

	1996	1995
Total Return	10.16%	5.41%
Less: Spending Policy	(5%)	(5%)
Change in CPI	(3%)	(3%)
Real Growth (Decline)	2.16%	(2.59%)

Given the performance of many peers in 1996—who commonly experienced a 13 percent to 16 percent return on investments—SanJo did not perform as well. Investment return would be an area in which the university could improve (see Table VII-11).

3. LIQUIDITY AND CASH FLOW RATIOS

The new financial statement formats for the first time require a cash flow statement. This provides trustees with new information, and accordingly, several new measures or ratios are expected to gain popularity with rating agencies. Most of these ratios are similar to those used for corporate enterprises that for several years have been required to provide cash flow statements in their financial statements.

External and internal users of financial reports focus on measures of an institution's liquidity and its cash flows. Liquidity considers an institution's ability to meet current operating costs, while cash flows provide the user with information on how the institution is meet-

TABLE VII-11

TOTAL RETURN LONG-TERM INVESTMENTS

Measures the investment performance for the period. Must be measured against the spending policy of the institution as well as a measure of inflation to determine if the investments are really achieving equity growth.

INVESTMENT INCOME PLUS REALIZED & UNREALIZED GAINS / AVERAGE LONG-TERM INVESTMENTS FOR THE PERIOD		**1996**	**1995**
	(B/A)	**10.16%**	**5.41%**
Long-term investments at the beginning of the year		240,743	236,100
Long-term investments at the end of the year		249,152	240,743
		489,895	476,843
Simple average of long-term investments	*(A)*	244,948	238,422
Realized and unrealized gains on investments		15,845	2,756
Investment income		9,053	10,152
(from Appendix A, footnote 4)	*(B)*	24,898	12,908

ing its investing needs and financing obligations. The statement of cash flows and related ratios help answer the strategic question: *What are the institution's sources of cash, and how has it used them for its operating, investing, and financing activities?*

Liquidity and cash flow ratios include (1) working capital, (2) operating cash flow to debt service, (3) deferred maintenance funding capability, and (4) nonliquid net assets.

Working Capital Ratio. This ratio measures the ability of an institution to meet its daily working capital requirements. It focuses on current assets relative to current liabilities. Current assets and current liabilities are those that an institution expects to convert to cash within one year. The ratio follows:

$$\frac{\text{Current Assets}}{\text{Current Liabilities}}$$

SanJo University has a strong working-capital ratio of 329 percent—or more than $3 of current assets to meet each $1 of current liabilities. With cash and short-term investments aggregating almost $27 million, some may question whether SanJo is *too* liquid (that it has too much working capital). Perhaps deploying more of its assets with long-term investments could help improve the university's total return on all investments (see Table VII-12).

Operating Cash Flow to Debt Service Ratio. This ratio measures the ability of an institution to meet debt service from its operating cash flow. The numerator represents the cash provided by operations; this number comes from the cash flow statement. The number also includes investment gains used for operations and interest expense. The denominator represents an institution's debt service, including principal and interest. The larger the ratio becomes, the greater is the likelihood that the institution can

TABLE VII-12

WORKING CAPITAL RATIO

Measures institution's ability to meet working capital requirements in due course.

Current assets include all unrestricted amounts expected to be converted to cash in the next 12 months (e.g., cash, cash equivalents, short-term investments, accounts receivable).
Current liabilities include all amounts payable or accrued which are expected to be paid during the next 12 months (e.g., it would exclude long term accruals such as for post-retirement benefits).

		1996	1995
CURRENT ASSETS / CURRENT LIABILITIES	*(A/B)*	**329%**	**290%**
Current Assets:			
Cash and cash equivalents		14,866	15,650
Accounts receivable, net		1,010	851
Short-term investments		11,993	11,327
Inventories		1,109	1,062
	(A)	28,978	28,890
Current Liabilities:			
Accounts payable and accrued expenses		5,903	7,188
Deposits and deferred revenues		2,897	2,759
	(B)	8,800	9,947

meet its debt service requirements from operating income (including investment gains earmarked for operations). Again, this ratio is a measure of financial viability. If the ratio falls below one, an institution would need other sources of financing to meet its current financing obligations.

Net Cash Provided by Operating Activities Plus Interest Expense
Debt Service (Principal Plus Interest)

Even though it has declined to 266 percent, SanJo University's operating cash flow to debt service ratio indicates the university could meet its debt service by a multiple of almost three based on the cash provided by its operations (see Table VII-13).

Deferred Maintenance Funding Capability Ratios. This ratio considers the ability of an institution to fund future repairs and replacements of plant assets from cash flows from its operations. Unfortunately, there is no easy way to measure *the size of an institution's financial needs* for deferred maintenance from its financial statements. In fact, two institutions with almost identical financial statements could have dramatically different deferred-maintenance needs. On the other hand, it is possible to measure *the funds that are available* to meet an institution's deferred-maintenance needs. To do so, we use historical cost depreciation and replacement cost depreciation as surrogates for funding deferred maintenance. The first deferred maintenance funding capability ratio follows:

Net Cash Provided by Operating Activities Minus Debt Service Principal
Depreciation Expense

The second ratio is a more conservative measure of the funds available for deferred maintenance. It uses replacement cost depreciation, which is one approximate measure of the current cost of maintaining and/or replacing an institution's physical plant. Although the ratio is imprecise, it allows an institution to determine—over several years—whether it is improving or falling behind in its ability to meet its deferred-maintenance needs.

TABLE VII-13

OPERATING CASH FLOW TO DEBT SERVICE

Measures ability of institution to meet debt service from operating cash flow.

NET CASH PROVIDED BY OPERATING ACTIVITIES PLUS INTEREST EXPENSE / DEBT SERVICE (PRINCIPAL & INTEREST)		1996	1995
	(A/B)	266%	310%
Net cash provided by operating activities (from Cash Flow Statement)		6,749	7,312
Investment gains used for operations		1,191	433
Interest expense (from Cash Flow Statement or footnotes)		2,952	2,114
	(A)	10,892	9,859
Interest expense (from cash flow statement or footnotes)		2,952	2,114
Required principal payments on debt (from Cash Flow Statement or footnotes)		1,141	1,068
	(B)	4,093	3,182

Net Cash Provided By Operating Activities Minus Debt Service Principal
Replacement Cost Depreciation Expense

For SanJo, the two ratios give a different picture of the university's ability to meet its deferred-maintenance needs. The ratio ranges from 148 percent under historical cost depreciation to 61 percent on a current cost basis. Both ratios indicate that funds are available to meet deferred-maintenance needs. However, without meaningful information about the true costs of deferred maintenance—which are difficult to estimate without a hands-on inspection— the complete picture remains elusive (see Table VII-14).

TABLE VII-14

DEFERRED MAINTENANCE FUNDING CAPABILITY

a. Measures the ability of the institution to fund historical cost depreciation as a surrogate for a deferred-maintenance provision. At best an imperfect measure.

NET CASH PROVIDED BY OPERATING ACTIVITIES LESS DEBT SERVICE PRINCIPAL / DEPRECIATION EXPENSE		1996 148%	1995 200%
Net cash provided by operating activities		6,749	7,312
Investment gains used for operations		1,191	433
Less: Debt service principal (payments from Cash Flow Statement)		(1,141)	(1,068)
	(A)	6,799	6,677
Depreciation expense (from Cash Flow Statement or footnotes)	*(B)*	4,601	3,342

b. Attempts to provide a better measure of the cash requirement to fund deferred maintenance.

NET CASH PROVIDED BY OPERATING ACTIVITIES LESS DEBT SERVICE PRINCIPAL / REPLACEMENT COST DEPRECIATION EXPENSE		1996 61%
	(A/C)	

Replacement cost depreciation is not typically available in the basic financial statements. However, many institutions use some method of estimating the expected cost of deferred maintenance. One imperfect method is to determine depreciation using estimated replacement cost, which should be available from insurance records, assuming normal coverage for property damage.

	($ in thousands) Historical Cost	Replacement Cost	Asset Life	Estimated Replacement Depreciation
Land and improvements	3,816	0		
Equipment and books	35,597	35,597	7	5,085
Construction in progress	16,634	16,634	35	475
Total other than buildings		52,231		
Insurance replacement cost estimate		245,000		
Estimate of buildings replacement cost	100,166	192,769	35	5,508
Total cost per financial statement footnotes	156,213			
Estimate of Replacement Cost Depreciation			*(C)*	11,068

Pledges Receivable Ratio. This ratio separates pledges from net assets, since pledges do not represent liquid assets at the end of the institution's fiscal year. Nevertheless, pledges represent future cash flows for the institution.

$$\frac{\text{Pledges Receivable}}{\text{Total Net Assets}}$$

At 4.49 percent in 1996, pledges represent an almost negligible portion of total net assets for SanJo University and therefore are not a concern. On the other hand, this ratio may indicate that there is a real need or opportunity to raise money on a longer term pledged basis (see Table VII-15).

SUMMARY

Ratio analysis attempts to capture certain financial information an institution's officials may find helpful. However, ratios do not provide complete answers to questions regarding a college or university's liquidity, solvency, operating performance, or financial flexibility. Qualitative factors also are important and offer significant information about the institution's financial health. Ratios serve as "red flags," especially if a ratio is increasing or decreasing significantly or is out of line with the ratio of a peer institution. Board members who understand the ratios for their college or university—and the explanations behind their fluctuations—have a valuable tool at their disposal.

TABLE VII-15

PLEDGES RECEIVABLE RATIO

Measures the portion of net assets which is made up of the net present value of recorded pledges.

		1996	1995
PLEDGES RECEIVABLE / TOTAL NET ASSETS	*(A/B)*	**4.49%**	**4.81%**
Pledges receivable		15,333	15,285
Total net assets at end of the year		341,413	317,563

8

EFFECTIVE INTERNAL ASSESSMENT OF FINANCIAL HEALTH

The preceding chapters of this book presented many ways to analyze the financial data in an institution's annual financial report. This chapter focuses on selecting, summarizing, and presenting the appropriate financial and nonfinancial data to include in the report. We will rely again on our hypothetical institution, SanJo University, to illustrate the analytical process.

An institution's annual financial report contains so much data that many trustees will not know where to turn first. Rather than trying to monitor every statement or indicator, trustees may want to review summarized information. The most critical measures are likely to vary from institution to institution. For example, some institutions may be most concerned about their dependence on tuition and the levels of student financial aid necessary to meet enrollment objectives. Others may be more concerned about the level of their deferred maintenance, their ability to carry additional debt, their "expensive policies," and so forth.

What's more, the most critical issues facing a particular institution are likely to change over time, so trustees periodically should reevaluate which information and measures are most important for their institution. Some measures can change quickly and demand attention each year—enrollment levels, tuition pricing sensitivity, and salaries, for example. Others may change more slowly, such as the progress of a capital campaign.

With the help of management, trustees should identify the financial and nonfinancial measures they want to monitor more closely than others. The source of these measures can be the financial statements (from which such measures as operating ratios can be calculated) or other supplemental information (such as the number of student applications and matriculation rates in a given year). Such measures can be qualitative (the quality of accepted students) as well as quantitative (the endowment ratio, percent of applicants admitted, and so forth). These financial and nonfinancial indicators can provide valuable information about an institution's financial health.

The institution's management should track its financial and nonfinancial indicators over several years (including those required by the financial markets for certain bond ratings or by lenders to meet established debt covenants) and, where possible, compare them with those of peer institutions or with those of institutions regarded as the "best in class" for a particular measure or attribute.

By itself, a measure cannot be labeled good or bad. It is only by comparison that a measure will serve as a red flag, alerting a trustee to the need for more discussion and inquiry with management. After trustees and administrators agree on the appropriate measures to monitor, reports need to be designed to help them do so. It is important that such reports:

- be driven by and relate closely to the institution's mission,
- use simple graphs and charts that are not overloaded with numbers, and
- interpret the financial data in each chart and graph clearly and concisely.

SANJO UNIVERSITY REVISITED

Let us turn once again to SanJo University. SanJo is a private university located outside a major metropolitan area. It is well regarded, although not in the top tier of institutions in terms of its selectivity, reputation, or "rankings" in the most recent *U.S. News & World Report* or other annual college guides. The university has a reputation for being managed well, and it has an active board. SanJo's mission is to provide an outstanding liberal arts undergraduate education as well as selected postgraduate programs.

Like many such statistical abstracts, SanJo's contains the type of supplemental data that often appears in an institution's annual report. Chart VIII-1 shows the university's FTE enrollment is 2,850 for the 1995-96 academic year, up from 2,750 FTE students in 1990-91, and from 2,650 FTE students in 1985-86. Although its applications for admissions have increased to

CHART VIII-1

SANJO UNIVERSITY STATISTICAL ABSTRACT

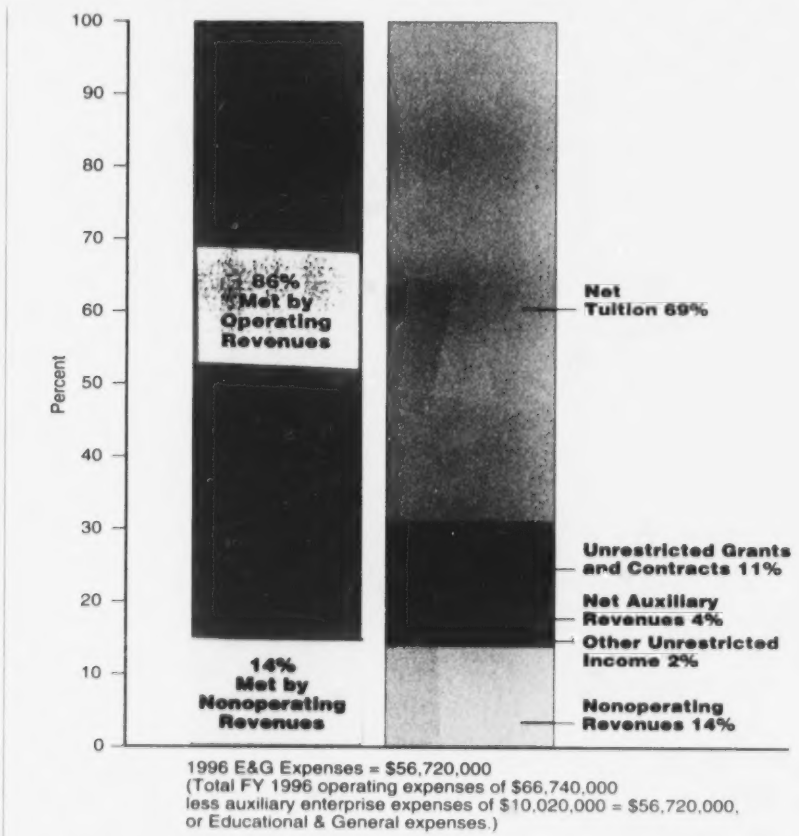
	1985/86	1990/91	1995/96
Endowment Market Value	$95,300,000	$147,800,000	$227,409,000
Endowment Per Student	$35,962	$53,745	$79,793
Total Private Gifts Received	$8,886,000	$8,818,000	$13,543,000
Number of Alumni Solicited	20,000	22,000	25,000
Percent of Alumni Donating	45.0%	50.0%	53.0%
Tuition, Fees, Room, and Board	$11,500	$16,860	$23,300
Educational Costs Subidized			
By Sources Other Than Tuition	$2,720	$3,985	$6,159
Student Aid:			
Total Financial Aid (Undergraduates)	$3,669,958	$7,354,686	$15,133,000
Percent of Students with University Grants	29.7%	31.3%	39.7%
Total Outside Grants	$1,023,556	$1,425,000	$1,800,000
Total Loans and Jobs	$2,048,000	$2,336,000	$4,100,000
Percent of Students With Need-Based Aid	37.2%	38.2%	44.0%
Student Enrollment (FTE)	2,650	2,750	2,850
Faculty (FTE)	200	226	231
Percent Tenured	50.0%	57.0%	65.0%
Student/Faculty Ratio	13.3	12.2	12.3
Total Faculty and Staff	700	705	700
Plant Replacement Value	$102,000,000	$170,000,000	$245,000,000
Gross Square Feet of Buildings	1,325,500	1,510,400	1,550,000
Replacement Cost Per Square Foot	$76.95	$112.55	$158.06
Applications for Admission	5,210	4,987	5,985
Percent of Applicants Offered Admission	35.0%	38.0%	44.0%
Yield on Admission Offers (% Enrolling)	28.0%	29.0%	27.0%
Graduation Rate	89.0%	87.0%	88.0%

5,985 in the 1995-96 academic year, its yield on enrollment (the percentage of students who actually enroll) has decreased slightly to 27 percent, and the percentage of applicants offered admission has increased significantly to 44 percent in 1995-96 (up from 35 percent in 1985-86).

SanJo's tuition, fees, room, and board also have increased significantly—from $11,500 in 1985-86 to $23,300 in 1995-96—making it a relatively expensive private institution. This represents an average annual increase of approximately 8 percent. (Although the statistical abstract for SanJo University does not provide such detail, trustees may want to see tuition and fees and then, separately, the cost of room and board.) You may recall from the previous chapter that SanJo's operating revenue ratio was almost 86 percent, indicating the university meets 86 percent of its E&G expenses with its operating revenue (see Chart VIII-2). In addition, net tuition revenues meet 69 percent of its E&G expenses.

CHART VIII-2

TUITION DEPENDENCY



1996 E&G Expenses = $56,720,000
(Total FY 1996 operating expenses of $66,740,000
less auxiliary enterprise expenses of $10,020,000 = $56,720,000,
or Educational & General expenses.)

See Table VII-1.

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TUITION DEPENDENCE

Clearly, one key issue for SanJo University is its dependence on tuition and its ability to attract students. This may raise certain questions for SanJo's trustees:

- How much has SanJo's tuition increased annually (as a percentage and in dollars)?
- How does the annual percentage increase in tuition compare with external measures, such as the CPI? How does it compare with the Higher Education Price Index? (This can be obtained from Research Associates of Washington by calling 202/966-3326.)
- How does the annual percentage tuition increase compare with that of SanJo's peers?
- How has the university's tuition dependency ratio changed over the last ten years?
- How sensitive is its enrollment to increases in tuition?
- What portion of its educational and general expenses are being met by tuition and fee revenue?
- How did actual tuition and fee revenue compare with budgeted tuition and fee levels? That is, was the institution able to maintain the enrollment levels it had planned to achieve?
- Could the institution increase the size of its student body beyond the 200 additional FTE students it already has added over the past ten years? That is, can the university physically accommodate more students in its dormitories? Can it support more students with its current administrative levels? Can it increase the size of its student body with its current level of faculty?

Few of these questions are easy to answer, and all require substantial analysis. For example, many factors influence the size of an institution's student body, and the price of tuition is only one of them. The number of applications, the percentage of applications accepted, the enrollment yield, and the retention rate together comprise "market demand." This represents the selectivity of the institution, which affects tuition revenue and cash flows. (The bond markets also look at SAT scores, rank in high school class, and other attributes of the student body as a measure of an institution's selectivity.) The most selective institutions are better able to cope with downturns in the numbers of applications. In contrast, a highly tuition-dependent institution that needs to accept a high percentage of applicants is more likely to experience financial difficulty, or at a minimum, a lower degree of financial flexibility.

FINANCIAL AID

As tuition and fees have increased and federal grants to students have diminished, institutions themselves have had to provide more aid to students. For colleges and universities with sufficient endowment income to support institutionally funded student aid, this is less of a problem. The greatest difficulty arises when this aid is *unfunded*.

You may recall from Chapter 7 that SanJo's tuition discount ratio was 28 percent, meaning the institution itself supplies more than one-quarter of the price of tuition to students through financial aid. Most of this aid comes from donors, or the university uses income from its endowment. But the unfunded portion was almost 10 percent, indicating that SanJo in effect is discounting tuition by almost 10 percent (see Chart VIII-3).

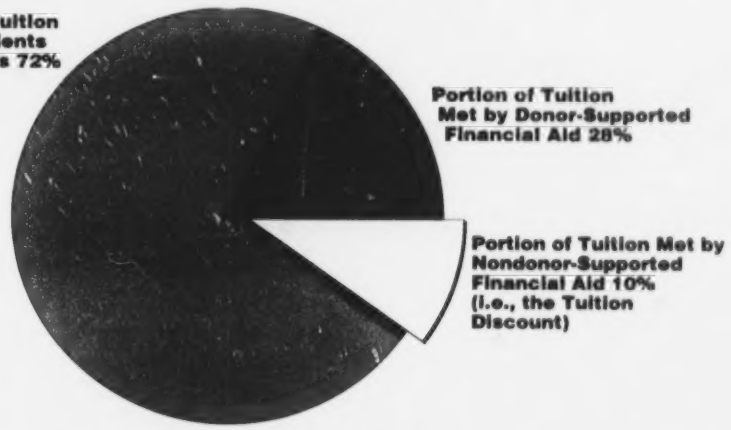
Referring to the statistical abstract in Chart VIII-1, university grants increased from $3.7 million in 1985-86 to $15.1 million in 1995-96, an increase of more than 300 percent. This compares with an increase in tuition, fees, room, and board of 100 percent over the same period.

As a result, the board might want to pursue the following questions with senior administrators:

- What has been the average increase in institutionally funded financial aid each year

CHART VIII-3

1996 TUITION DISCOUNT


Portion of Tuition Met by Students and Families 72%
Portion of Tuition Met by Donor-Supported Financial Aid 28%
Portion of Tuition Met by Nondonor-Supported Financial Aid 10% (i.e., the Tuition Discount)

Of SanJo University's $54 million tuition and fee revenue in 1996, 28 percent is met by financial aid. Almost 10 percent is nondonor-supported financial aid, which is effectively a discount in order to achieve enrollment objectives. *See Table VII-2.*

compared with the average increase in tuition and fees?

- If the current level of aid is continued, how much would the university project it would need over the next five to ten years? How does this compare with projected tuition and fee increases?
- What is SanJo's financial-aid packaging strategy?
- Are financial-aid applicants "gapped"? That is, is the institution meeting only a portion of each student's full need? What is the trend in the institution's gapping policy?
- What is the percentage of students who receive financial aid? What is the size of the average grant? How has the size of the average grant changed over the past ten years? (The statistical abstract indicates the percentage of students receiving university grants has risen from 30 percent to 40 percent over the past ten years, and the institutional-aid budget has increased by more than 300 percent. In addition, the percent of students with need-based aid has increased from 37 percent to 44 percent.)
- How do the financial-aid polices of SanJo University compare with those of its peers?
- Has the increase in the financial-aid budget been driven by the nature of SanJo's applicants or by competitive strategies of peer institutions? That is, are more students and parents demanding that SanJo meet the aid awards of other institutions? Given the price of tuition, many families are choosing institutions based on net cost after financial aid.

ENDOWMENT

As operating costs have increased at a rate far greater than the CPI, most institutions have raised tuition accordingly and have turned to private gifts and income from endowment as well. Gifts, grants, and endowment income increase an institution's operating flexibility and

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enable it to leverage other operating revenues, especially tuition. Two key determinants of the flexibility and financial strength of an institution are endowment size and endowment return. An institution can use this income to meet operating expenses, support financial aid, and increase the institution's permanent capital.

For SanJo, the market value of the endowment has increased from $95.3 million in 1985–86 to $227.4 million in 1995–96, an increase of 139 percent. Many of the financial strength ratios discussed in Chapter 7 are based on information regarding the endowment. These include endowment to operating expenses, quasi-endowment to total endowment, endowment per FTE, and total return on investments.

SanJo's endowment ratios have remained fairly constant or have improved over the last two years. For example, the university's endowment has continued to grow, more than keeping pace with the increase in the size of its student body. In addition, the university's total endowment is more than three times the size of its operating expenses (see Chart VIII-4). (Institutions with higher ratios have greater financial flexibility.) Although the endowment has grown significantly during the past ten years, the investment returns have not significantly contributed to that growth in the most recent years. After considering SanJo's spending policy of 5 percent and inflation of 3 percent to 4 percent, the institution's total returns of 10 percent and 5 percent, respectively, in the past two years are disappointing (see Chart VIII-4).

The ratio of quasi-endowment to total endowment also is an indicator of an institution's flexibility. Quasi-endowment is unrestricted and therefore available for use by the institution. Here again, SanJo's ratios have remained relatively constant. Chart VIII-4 on page 69 summarizes the endowment ratios for SanJo.

The board may want to ask the following questions related to SanJo's endowment:

- What is the institution's endowment-spending policy? That is, how much endowment income and realized gains does the institution allocate to operations?
- Have there been significant differences between the amounts the institution actually has spent and the budgeted amounts under the spending policy?
- What is the total annual return on long-term investments? How does this return compare with the market average? To the return of peer institutions? To its own budget?
- What is the investment strategy of the institution, and what level of risk has it accepted in its portfolio?
- How many of SanJo's alumni donate to the university each year? What is the average size of their gifts? (Many rankings of colleges and universities use "percentage of alumni who give" as a surrogate for alumni satisfaction with the institution. Therefore, not only does giving affect operating revenues and endowment, but it also may affect the institution's rankings.)
- How does the institution distinguish between annual giving and incremental giving through capital campaigns?
- Have the university's recent capital campaigns been successful?
- What is the trend in annual giving? What goals has the board established? Has the institution met them?
- What level of financial support have board members made to the institution?
- What efforts is the institution directing to corporate and foundation gifts?

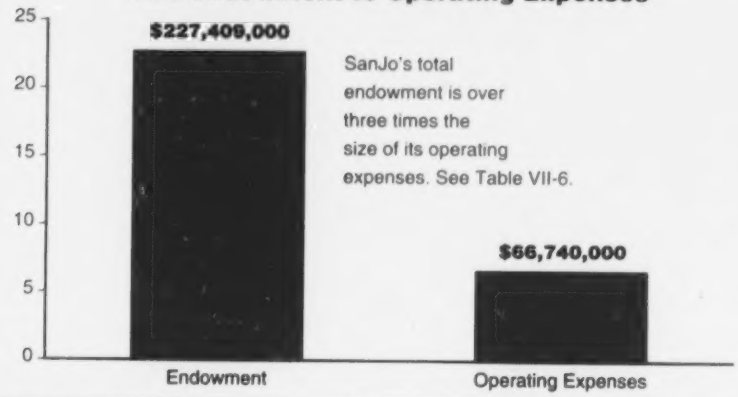
COSTS

Over the past decade, expenses for salaries, fringe benefits, and technology have increased at a rate far exceeding inflation as higher education institutions attempted to obtain and retain resources in a competitive marketplace. Although institutions passed on much of these costs in the form of tuition increases, the days of double-digit percentage increases in tuition are gone. Cost control is paramount at all institutions. It now is common for an institution to

CHART VIII-4

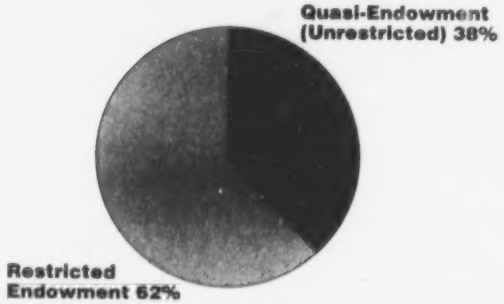
SUMMARY OF ENDOWMENT RATIOS

1996 Endowment to Operating Expenses



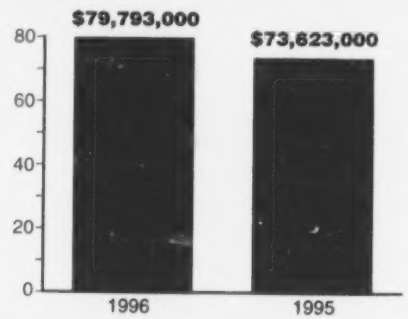
SanJo's total endowment is over three times the size of its operating expenses. See Table VII-6.

1996 Quasi-Endowment to Total Endowment



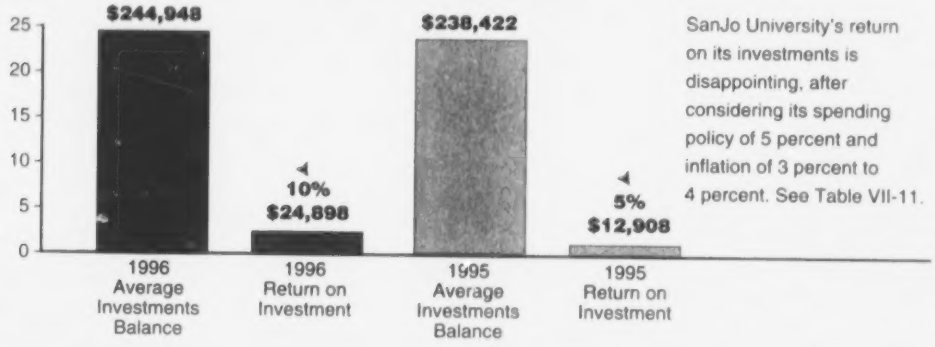
SanJo's quasi-endowment represents more than one-third of its total endowment of $227.4 million. See Table VII-7.

Endowment per FTE Student



The university's endowment continues to grow, more than keeping pace with the increase in the size of its student body from 2,800 students in 1995 to 2,850 students in 1996. See Table VII-8.

Return on Investments



SanJo University's return on its investments is disappointing, after considering its spending policy of 5 percent and inflation of 3 percent to 4 percent. See Table VII-11.

determine a maximum allowable percentage increase in tuition and fees and then adjust institutional costs to fit the price increase the market will bear.

Consequently, it is important for the board to understand the institution's costs and the key policies that affect them. (See the discussion of "expensive policies" in Chapter 2.) Financial information should be used to evaluate an institution's policies but should not determine them. It is the responsibility of the board to set and monitor policies that support the institution's mission.

The statement of activities classifies expenses by functional area, such as institutional and academic support. While such classification provides board members with information about the cost of different programs, it also is beneficial to review expenses according to natural classifications, such as salaries and employee benefits. Some institutions have created a matrix that allows for analyzing these costs along both dimensions—functional and natural.

For SanJo University, a number of operating ratios relate the institution's expenses to other measures. Chapter 7 presented SanJo's expenses compared with its operating revenues, unrestricted net assets, and debt service. For example, the university's operating revenue (income from tuition and fees) is meeting a growing percentage of its operating expenses, implying greater tuition dependency. Unrestricted net assets as a percent of operating expenses plus debt service principal is declining, implying somewhat less flexibility. This also indicates that expenses are increasing faster than the university's unrestricted net asset balance.

Questions related to an institution's costs include the following:

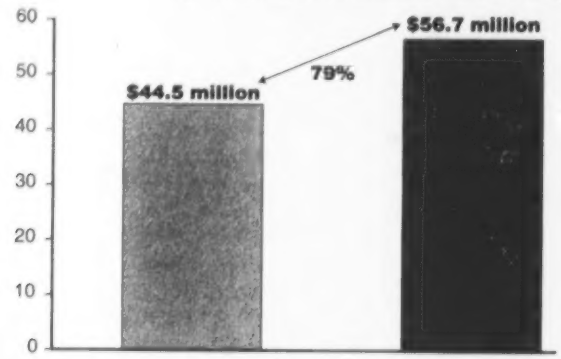
- What are the key expenses driving its overall costs?
- What has been the trend for these expenses over time?
- How have program costs changed over time? Are more or fewer funds flowing to instructional, research, and support functions?
- How has the institution fared regarding deferred maintenance? What is the effect of using replacement-cost depreciation when analyzing the amount of cash provided by operations (liquidity and cash flow ratios referred to in Chapter 7)?
- Has the institution had to draw on its long-term assets to fund operating expenses?
- Do auxiliary revenues equal or exceed auxiliary expenses? That is, are housing and food-service costs fully covered by the revenue they generate?
- Is the institution adding or deleting programs, and what are the current and future implications of such decisions?
- How did the university's actual expenses compare with budgeted expenses? What are the causes of any variances?
- Has the number of university personnel remained constant, or is it increasing or decreasing in different program areas? Has the number of faculty, administrators, and support staff increased over the last ten years? If there is growth, is it being controlled? (Since salaries and employee benefits represent the most significant portion of total costs, this information is critical to the analysis.)
- How has the student-faculty ratio changed over time? How has this affected costs?

Much of the detailed information on costs and expenses is not available in the financial statements. However, comparative information on an aggregated basis allows the trustees to measure overall performance and focus more detailed analysis on areas that need attention. Therefore, the board may want administrators to provide such information in supplemental disclosures and reports to the board. Trend in-

CHART VIII-5

SUMMARY OF OPERATING RATIOS

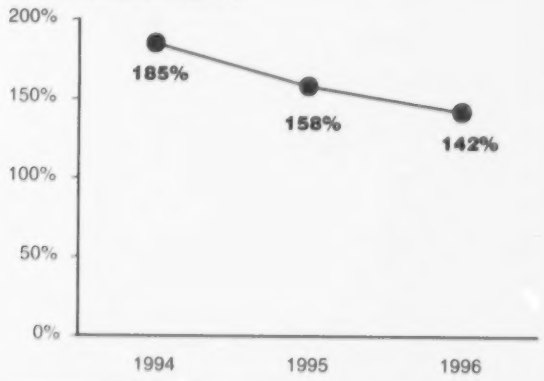
Operating Revenue to E&G Expenses



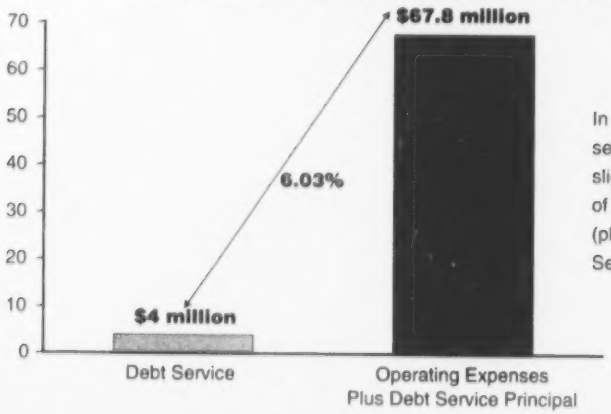
Approximately 79 percent of SanJo University's Educational and General Expenses in 1996 were met by its operating revenues. See Table VII-1.

Expendable Net Assets Ratio

SanJo's Expendable Net Assets Ratio, which measures unrestricted revenues available to meet one year's operating costs plus the principal portion of the debt service, has declined from 1994 to 1996, indicating that its financial flexibility is slightly weakening. See Table VII-4.



Debt Service to Operating Expenses Ratio



In 1996, SanJo's debt service represented slightly over 6 percent of its operating expenses (plus debt service principal). See Table VII-5.

formation on expenses is a key component of analyzing the financial health of an institution.

USE OF DEBT

Many institutions have used debt, particularly tax-exempt debt, to finance projects rather than commit other capital resources. This is an especially attractive way to finance such self-supporting projects as dormitories, dining halls, or other facilities that generate revenue. When the returns on endowment and similar funds are a multiple of the institution's incremental borrowing rate, the institution would be especially wise to use such leverage to finance capital projects. Before deciding to incur any new debt, the institution will want to assess how it is handling its existing debt within budgetary constraints. Trustees will want to pay attention to several ratios when considering the effect of new debt on the institution:

- Expendable net asset ratios—What would be the relationship of expendable net assets to operating expenses plus debt service if the institution issued new debt?
- Debt service ratios—What percent of the total operating budget (including required debt

TABLE VIII-6

IMPACT OF ADDING DEBT

Key Ratio	Actual Ratio 1996	Proforma* Ratio
Expendable Net Asset Ratios		
a. UNRESTRICTED NET ASSETS LESS NET INVESTMENT IN PLANT / OPERATING EXPENSES & DEBT SERVICE PRINCIPAL	142%	138%
b. EXPENDABLE NET ASSETS LESS NET INVESTMENT IN PLANT / OPERATING EXPENSES & DEBT SERVICE PRINCIPAL	294%	286%
Debt Service Ratios		
a. ANNUAL DEBT SERVICE / OPERATING EXPENSES & DEBT SERVICE PRINCIPAL	6.03%	8.58%
b. OPERATING SURPLUS PLUS INTEREST EXPENSE / ANNUAL DEBT SERVICE	157%	108%
Total Debt to Expendable Net Assets Ratio		
a. TOTAL DEBT OUTSTANDING / UNRESTRICTED NET ASSETS LESS NET INVESTMENT IN PLANT	50.52%	71.31%
b. TOTAL DEBT OUTSTANDING / UNRESTRICTED & TEMPORARILY RESTRICTED NET ASSETS LESS NET INVESTMENT IN PLANT	24.33%	34.34%

*This analysis presents a proforma of what the ratios for SanJo would look like if the university borrowed an additional 20 million over 15 years, assuming a borrowing cost of 5 percent.

principal payments) goes for debt service? What will be the debt coverage ratio with the new debt? Will the institution still cover all of its debt service requirements with its operating surplus?

- Total debt to expendable net assets ratios—What will be the relationship of the new debt levels to the institution's available unrestricted net assets (unrestricted net assets less investment in plant net of existing debt)? What will be the relationship of the new debt levels to the institution's expendable net assets (unrestricted net assets plus temporarily restricted net assets less investment in plant net of existing debt)?

Also, if the institution chooses to use quasi-endowment rather than finance the project, this would affect several other ratios. Turning again to SanJo University, let us look at the effect of issuing an additional $20 million of debt over 15 years, assuming a borrowing cost of 5 percent. The annual debt service would be $1.89 million, which would affect each of SanJo's key ratios.

The expendable net asset ratios would not change much, but the effect of the new debt service on the budget would be significant. Debt service would be almost 9 percent of operating costs. Debt service coverage would approach the 100 percent threshold below which an institution does not want to fall. Outstanding debt would increase dramatically in relation to the expendable net assets. This would not necessarily indicate that the university should not borrow more, but it should cause SanJo to evaluate carefully just how it will repay this debt and to be sure to frame these decisions in the context of the institution's other long-term needs (see Table VIII-6).

SUMMARY

Identifying the key issues for your institution and the key financial indicators that relate to those issues is the first important step in measuring progress. Trustees must agree with administrators on the key issues and on the measures that routinely will be prepared and explained at meetings of the board or its finance committee. The information should include trends for several accounting periods, and it periodically should be compared with data from peer institutions, with regional and national averages, and with institutions considered "best in class."

Asking and understanding the answers to the right questions is essential. We hope we have provided not only some of the key questions but also a framework within which to capture the data that will provide some of the answers. Our goal has been to bring the key questions and issues into clearer focus for board members, allowing them to make the strategic decisions necessary for the survival and growth of their institutions.

APPENDIX A

SANJO UNIVERSITY FINANCIAL STATEMENTS

For the year ended June 30, 1996 (with comparative totals for 1995)

TABLE A-1

FINANCIAL STATEMENTS

SanJo University
Statement of Financial Position
June 30, 1996 and 1995 (in thousands)

	1996	1995
Assets		
Cash and cash equivalents	$14,866	$15,650
Accounts receivable, net	1,010	851
Short-term investments	11,993	11,327
Inventories	1,109	1,062
Prepaid expenses and other assets	2,130	2,148
Pledges receivable, net	15,333	15,285
Student loans receivable, net	2,716	2,764
Long-term investments, at market	249,152	240,743
Land, buildings and equipment, net	109,626	96,211
Total assets	$407,935	$386,041
Liabilities		
Accounts payable and accrued expenses	5,903	7,188
Deposits and deferred revenues	2,897	2,759
Postretirement benefits	6,312	6,029
Federal student loan funds	2,831	2,782
Long-term debt	48,579	49,720
Total liabilities	66,522	68,478
Net Assets		
Unrestricted	157,212	147,342
Temporarily restricted	103,537	93,522
Permanently restricted	80,664	76,699
Total net assets	341,413	317,563
Total liabilities and net assets	$407,935	$386,041

The accompanying notes are an integral part of the financial statements.

TABLE A-2

FINANCIAL STATEMENTS

SanJo University
Statement of Activities
For the year ended June 30, 1996
with comparative totals for 1995 (in thousands)

	Unrestricted	Temporarily Restricted	Permanently Restricted	1996 Total	1995 Total
Operating Revenues					
Tuition and fees	$54,298			$54,298	$49,077
University sponsored financial aid	(5,145)			(5,145)	(4,446)
Donor sponsored financial aid	(9,988)			(9,988)	(8,892)
Net tuition and fees	39,165			39,165	35,739
Sales and services of auxiliaries	12,099			12,099	10,628
Government grants and contracts	1,991			1,991	1,684
Private gifts and grants	4,084	2,639		6,723	5,647
Long-term investment income	4,110	4,943		9,053	10,152
Investment gains used for operations	1,191	1,456		2,647	963
Other income	1,314			1,314	1,285
Net assets released from restrictions	6,266	(6,266)			
Total operating revenues	70,220	2,772		72,992	66,098
Operating Expenses					
Instruction and research	27,619			27,619	25,783
Athletics	6,001			6,001	5,499
Academic support	6,367			6,367	6,321
Student services	6,085			6,085	5,643
Institutional support	10,648			10,648	10,472
Auxiliary enterprises	10,020			10,020	8,845
Total operating expenses	66,740			66,740	62,563
Increase in net assets from operating activities	3,480	2,772		6,252	3,535
Nonoperating Activities					
Investment gains reinvested	5,024	8,174		13,198	1,793
Capital gifts	934	1,921	3,965	6,820	8,511
Other	(1,197)	(1,223)		(2,420)	(969)
Net assets released from restrictions	1,629	(1,629)			
Increase in net assets from nonoperating activities	6,390	7,243	3,965	17,598	9,335
Net increase in net assets for the year before change in accounting	9,870	10,015	3,965	23,850	12,870
Effect of changes in accounting:					
Contributions pledged					15,285
Postretirement benefits					(5,645)
Net increase in net assets	9,870	10,015	3,965	23,850	22,510
Net assets at beginning of year	147,342	93,522	76,699	317,563	295,052
Net assets at end of year	$157,212	$103,537	$80,664	$341,413	$317,562

The accompanying notes are an integral part of the financial statements.

TABLE A-3

FINANCIAL STATEMENTS

SanJo University
Statement of Cash Flows
For the years ended June 30, 1996 and 1995 (in thousands)

	1996	1995
Cash Flows From Operating Activities		
Change in net assets	$23,850	$22,510
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Depreciation and amortization	4,684	3,866
Gains on investments	(15,845)	(2,756)
Gain on equipment disposals	(99)	(63)
Capital gifts	(5,886)	(7,151)
Other nonoperating activity	1,698	257
Changes in assets and liabilities that provide (use) cash:		
Accounts receivable	(159)	(71)
Pledges receivable	(48)	(15,285)
Student loans receivable	48	46
Short-term investments	(666)	(221)
Inventories	(47)	(56)
Prepaid expenses and other assets	65	(74)
Accounts payable and accrued expenses	(1,285)	1,594
Deposits and deferred revenues	138	165
Postretirement benefits	283	6,029
Other changes	18	(1,478)
Net cash provided by operating activities	6,749	7,312
Cash Flows From Investing Activities		
Purchases of plant and equipment, net	(18,016)	(18,909)
Purchases of investments	(265,934)	(337,735)
Proceeds from sales and maturities of investments	273,370	336,969
Other nonoperating activity	(1,698)	(257)
Net cash used in investing activities	(12,278)	(19,932)
Cash Flows From Financing Activities		
Proceeds from contributions for:		
Investment in endowment	3,965	4,851
Investment in long-lived assets	1,921	2,300
Proceeds from issuance of long-term debt		
Payments on long-term debt	(1,141)	(1,068)
Net cash provided by financing activities	4,745	6,083
Net decrease in cash and cash equivalents	(784)	(6,537)
Cash and cash equivalents, beginning of year	15,650	22,187
Cash and cash equivalents, end of year	$14,866	$15,650
Supplemental Data		
Noncash investing and financing activities—gifts in kind	$412	$580
Interest paid	$2,952	$2,114

The accompanying notes are an integral part of the financial statements.

NOTES TO THE FINANCIAL STATEMENTS

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

(a) Basis of Presentation

The financial statements of SanJo University (the University) have been prepared on the accrual basis of accounting.

During 1995, the University adopted the provisions of Statement of Financial Accounting Standards (SFAS) No. 116, "Accounting for Contributions Received and Made," and SFAS No. 117, "Financial Statements of Not-For-Profit Organizations," and applied the standard on a retroactive basis. SFAS No. 116 requires that unconditional promises to give (pledges) be recorded as amounts receivable and revenues within the appropriate net asset category. SFAS No. 117 establishes standards for external financial reporting by not-for-profit organizations. Resources are reported for accounting purposes, in separate classes of net assets based on the existence or absence of donor-imposed restrictions. In the accompanying financial statements, net assets that have similar characteristics have been combined into similar categories as follows:

Permanently restricted — Net assets subject to donor-imposed stipulations that they be maintained permanently by the University. Generally, the donors of these assets permit the University to use all or part of the investment return on these assets. Such assets primarily include the University's permanent endowment funds.

Temporarily restricted — Net assets whose use by the University is subject to donor-imposed stipulations that can be fulfilled by actions of the University pursuant to those stipulations or that expire by the passage of time.

Unrestricted — Net assets that are not subject to donor-imposed stipulations. Unrestricted net assets may be designed for specific purposes by action of the Board of Trustees or may otherwise be limited by contractual agreements with outside parties.

Revenues are reported as increases in unrestricted net assets unless use of the related assets is limited by donor-imposed restrictions. Expenses are generally reported as decreases in unrestricted net assets. Realized and unrealized gains and losses on investments and other assets or liabilities are reported as increases or decreases in unrestricted net assets unless their use is restricted by explicit donor stipulation or by law. Expirations of donor-imposed stipulations that simultaneously increase one class of net assets and decrease another are reported as reclassifications between the applicable classes of net assets.

Contributions, including unconditional pledges, are recognized as revenues in the period received. Conditional pledges are not recognized until the conditions on which they depend are substantially met. Gifts of securities are recorded at their fair market value when received. Pledges are recorded net of an allowance for amounts estimated to be uncollectible and a discount to reflect the present value of the expected future cash amounts to be received.

Contributions and investment return with donor-imposed restrictions are reported as temporarily restricted revenues and are reclassified to unrestricted net assets when an expense is incurred that satisfies the donor-imposed restriction. Contributions restricted for the acquisition of land, buildings, and equipment are reported as temporarily restricted revenues. These contributions are reclassified to unrestricted net assets upon acquisition of the assets.

Nonoperating activities reflect transactions of a capital nature, that is, contributions to be used for facilities and equipment or to be invested by the University to generate a return that will support operations.

(b) Investments

The University accounts for its investments at market value, and accordingly, the carrying amount approximates fair value. Net appreciation (depreciation) in the fair value of investments, which consists of the realized gains or losses and the unrealized appreciation (depreciation) on those investments, is shown in the Statement of Activities. The average cost of investment securities sold is used to determine the basis for computing realized gains and losses.

The value of publicly traded fixed income and equity securities is based upon quoted market prices and exchange rates, if applicable. The market value of significant real estate investments is determined from valuations prepared by independent appraisers. Private equities and certain other nonmarketable securities are valued using current information obtained from the general partner or investment manager for the respective funds.

Under the terms of certain limited partnership agreements, the University is obligated to periodically advance additional funding for private equity and real estate investments. At June 30, 1996, the University had commitments of approximately $5,000,000 for which capital calls had not been exercised. Such commitments generally have fixed expiration dates or other termination clauses. The University maintains sufficient liquidity in its investment portfolio to cover such calls.

(c) Endowment Investment Return Spending Policy

The University has an endowment and similar funds investment return spending policy which permits spending at the rate of 5% of the average market value of the endowment. Any income earned in excess of the spending limit is reinvested, while funds may be withdrawn from investment return earned in prior years if income is less than the spending limit.

(d) Inventories

Inventories are stated at the lower of cost (first-in, first-out method) or market.

(e) Student Loans Receivable

Student loans receivable at June 30, 1996 and 1995, are reported net of provisions for doubtful loans of $139,460 and $154,000, respectively. The provision is intended to provide for loans, both in repayment status and not yet in repayment status (borrowers still in school or in the grace period following graduation), that may not be collected. Notes receivable are principally amounts due from students under federally sponsored loan programs which are subject to significant restrictions. Accordingly, it is not practicable to determine the fair value of such amounts.

(f) Land, Buildings and Equipment

Land, buildings, and equipment are recorded at cost, or if donated, at fair market value at the date of donation. Depreciation is computed on a straight-line basis over the estimated useful lives of the related assets as follows:

	Years
Land improvements	7–10
Buildings and improvements	20–50
Equipment and library books	3–10

(g) Cash Equivalents

Cash equivalents include short-term, highly liquid investments with a maturity of three months or less when purchased. Cash and cash equivalents representing assets of endowment and similar funds and annuity and life income funds are included in long-term investments. Cash and cash equivalents are reported at cost which approximates fair value.

(i) Internal Revenue Code Status

The University has been granted tax-exempt status as a nonprofit organization under Section 501(c)(3) of the Internal Revenue Code.

2. CONTRIBUTIONS

Pledges outstanding at June 30, 1996 and 1995 (dollars in thousands) are summarized as follows:

	1996	1995
Unconditional promises expected to be collected:		
Less than one year	$7,039	$7,800
One year to five years	10,875	10,127
More than five years	1,646	1,500
Total gross pledges	19,560	19,427
Less: Allowance for uncollectible amounts	(1,467)	(1,457)
Discount to present value	(2,760)	(2,685)
Total pledges, net	$15,333	$15,285
Total cash contributions received	$13,495	$14,158
Fund-raising costs incurred	$2,708	$2,531

The discount to present value was calculated using a discount factor based on U.S Treasury Note rates for the respective pledges.

3. LAND, BUILDINGS, AND EQUIPMENT

Investment in land, buildings, and equipment consist of the following at June 30:

	(in thousands)	
	1996	**1995**
Land and improvements	$3,816	$3,412
Buildings	100,166	86,321
Equipment and books	35,597	31,710
Construction in progress	16,634	17,021
	156,213	138,464
Less: Accumulated depreciation	(46,587)	(42,253)
	$109,626	$96,211
Depreciation expense	$4,601	$3,342

Outstanding commitments for construction contracts amounted to approximately $2,600,000 as of June 30, 1996.

4. INVESTMENTS

Investments are stated at fair market value. Long-term investments by type consist of the following as of June 30:

	(in thousands)			
	1996		**1995**	
	Cost	**Market**	**Cost**	**Market**
Cash equivalents	$21,494	$21,496	$30,493	$30,563
Fixed-income investments—Bonds	89,158	91,249	86,775	85,720
Equity investments—Stocks	112,786	134,615	101,043	122,586
Other	1,758	1,792	1,857	1,874
	$225,196	$249,152	$220,168	$240,743

Short-term investments primarily include securities with maturities of up to three years at the time of purchase.

The components of total investment return from all sources for 1996 and 1995 reflected net of related management and custodial expenses of $3,065,000 and $2,878,000, respectively were (dollars in thousands):

	1996	**1995**
Interest income and dividends	$9,053	$10,152
Realized and unrealized gains, net	15,845	2,756
	$24,898	$12,908

Total returns, consisting of realized and unrealized gains and losses, dividends and interest income, as a percent of the average market value were 10.1 percent and 5.4 percent per unit for the years ended June 30, 1996 and 1995, respectively.

Pooled Funds

Endowment and similar funds assets are pooled on a unit market value basis whenever possible. Funds are added to or withdrawn from the pool at the unit market value at the beginning of the fiscal quarter in which the transaction takes place. Pooled funds were as follows as of June 30:

	1996	1995
Investments in pooled funds, at market value	$211,262,531	$196,014,499
Total number of units	23,924,877	23,616,122
Market value per unit	$8.83	$8.30
Average annual investment earnings per unit, exclusive of net realized gains	$0.31	$0.27

5. LONG-TERM OBLIGATIONS

Long-term obligations of plant funds at June 30, are summarized as follows:

	(in thousands)	
	1996	1995
State Dormitory Authority Issue:		
Series A, 5.53%, due 2003	$ 1,065	1,165
Series B, 5.13%, due 2007	1,900	2,000
Pooled Capital Revenue Bonds (1990), 7.80%, due 2002	5,789	6,199
Pooled Short-Term Revenue Bonds (1989), variable rate, due 2000	1,190	1,521
Series C, 6.46%, due 2021	18,635	18,835
Series D, 5.37%, due 2023	20,000	20,000
	$48,579	$49,720

Based on rates currently available to the University for debt with similar terms and remaining maturities, the estimated fair value of the University's total existing debt approximates its carrying amount.

The various notes and bonds are collateralized by the related property and equipment as well as certain pledges of tuition and fees. Most of the agreements require the establishment of debt service and building and equipment reserves. Principal maturities of the long-term obligations are as follows:

	(in thousands)
1997	$ 1,214
1998	1,286
1999	1,763
2000	1,428
2001	1,437
2002–2024	41,451
Total principal payments	$48,579

6. BENEFIT PLANS

(a) All employees who have completed one year of full-time service at the University are eligible for the University's retirement plan. All retirement benefits are funded and vested under a defined contribution program. The University's contributions to the plan amounted to approximately $2,549,000 and $2,462,000 in 1996 and 1995, respectively.

(b) The University provides health and life insurance benefits for eligible retired employees and their dependents. Effective June 1, 1994, the University adopted SFAS No. 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions". This statement requires that the cost of postretirement benefits be accrued during the service lives of employees. The University elected the immediate recognition method.

The following sets forth the plan status with amounts reported in the University's financial statements at June 30, 1996 and 1995 (dollars in thousands):

	1996	1995
Accumulated postretirement benefit obligation (APBO):		
Retirees	$3,316	3,155
Active plan participants fully eligible	639	607
Other active plan participants not yet fully eligible	2,357	2,267
	$6,312	$ 6,029

Net periodic postretirement benefit cost for the years ended May 31, 1995 and 1994 included the following components:

	1996	1995
Service cost-benefits attributed to service during the period	$175	171
Interest cost on accumulated postretirement benefit obligation	514	494
Net periodic postretirement benefit cost	$689	$665

An 8 percent annual rate of increase in the per capita costs of covered health care benefits was assumed for 1996, gradually decreasing to 5 percent by the year 2009. Increasing the assumed health care cost trend rates by one percentage point in each year would increase the medical portion of accumulated postretirement benefit obligation as of June 30, 1996, by $707,037 and increase the aggregate of the service cost and interest cost components of net periodic postretirement benefit cost for 1996 by $104,381. A discount rate of 8 percent was used to determine the accumulated postretirement benefit obligation.

7. COMPOSITION OF NET ASSETS

The composition of the various net assets of the University at the respective years ended on June 30 were as follows:

	1996	1995
Unrestricted Net Assets:		
Available for operating needs	$ 5,396	$ 4,744
Designated by the board for specific purposes	4,500	10,300
Funds functioning as endowment & accumulated gains on permanent endowment whose income is unrestricted	86,269	85,807
Investment in plant, net of long-term debt	61,047	46,491
	157,212	147,342
Temporarily Restricted Net Assets:		
Accumulated gains on permanent endowment whose income is donor restricted	60,476	43,637
Amounts restricted by donors for specific purposes	37,890	44,729
Pledges receivable for specific purposes	5,171	5,156
	103,537	93,522
Permanently Restricted Net Assets:		
Permanent endowment & similar funds	70,517	66,570
Pledges for permanent endowment	10,147	10,129
	$ 80,664	$ 76,699

APPENDIX B

SANJO UNIVERSITY FINANCIAL RATIOS

SANJO UNIVERSITY OPERATING RATIOS

TABLE B-1

OPERATING REVENUE RATIO

Measures dependency on operating revenue (principally net tuition and fees) to meet operating expenses.

		1996	1995	1994
OPERATING REVENUE / EDUCATIONAL & GENERAL EXPENSE	*(A/B)*	78.54%	75.38%	76.83%
Operating Revenue includes:				
1. Net Tuition		39,165	35,739	34,728
2. Auxiliary Enterprise Revenue		12,099	10,628	10,378
Less: Auxiliary Enterprise Expenses		(10,020)	(8,845)	(8,364)
3. Unrestricted Grants & Contracts		1,991	1,684	1,909
4. Other Unrestricted Income (excluding long-term investment income, gains used for operations & contributions)		1,314	1,285	898
	(A)	44,549	40,491	39,549
Educational & General Expense includes:				
1. All Operating Expenses		66,740	62,563	59,841
2. Auxiliary Operating Expenses (netted vs. revenues in numerator)		(10,020)	(8,845)	(8,364)
	(B)	56,720	53,718	51,477

Note: Debt service and depreciation are included functionally in operating expenses.

TABLE B-2

TUITION DISCOUNT RATIOS

Measures percent of financial aid that is donor supported and the portion that is effectively an institutional discount made to achieve enrollment objectives.

		1996	1995	1994
a. **TOTAL FINANCIAL AID / TUITION AND FEES**	*(B/C)*	27.87%	27.18%	24.96%
b. **NONDONOR SUPPORTED FINANCIAL AID / TUITION AND FEES**	*(A/C)*	9.48%	9.06%	8.32%
a. Financial aid includes all aid from all sources provided by the institution.				
University-Sponsored Financial Aid	*(A)*	5,145	4,446	3,852
Donor-Sponsored Financial Aid		9,988	8,892	7,702
Total Financial Aid	*(B)*	15,133	13,338	11,554
Tuition and Fees	*(C)*	54,298	49,077	46,282

b. Nondonor supported financial aid includes all aid provided by the institutions from its operating budget other than donor funds or true endowment income for scholarships.

SANJO UNIVERSITY OPERATING RATIOS

TABLE B-3

NET OPERATING INCOME RATIO

Measures return on revenues (sales).

		1996	1995	1994
a. Excluding Investment Income & Contributions				
NET OPERATING SURPLUS (DEFICIT) WITHOUT INVESTMENT INCOME & CONTRIBUTIONS / TOTAL OPERATING REVENUE	*(A/C)*	–17.33%	–20.51%	–19.32%
Net operating income (deficit) excluding income from donor-restricted investments (e.g., endowment income) and contributions. Basically all operating income from exchange type transactions divided by the net income from such transactions:				
1. Increase in unrestricted net assets from operations	*(B)*	3,480	1,933	1,904
2. Less: Long-term investment income		(4,110)	(5,120)	(5,463)
Investment gains used for operations		(1,191)	(433)	
Unrestricted private gifts and grants		(4,084)	(3,875)	(3,566)
Temporarily restricted net assets released from restrictions		(6,266)	(5,732)	(4,803)
	(A)	(12,171)	(13,227)	(11,928)
b. Reported Net Operating Income				
NET OPERATING INCOME (DEFICIT) / TOTAL OPERATING REVENUE	*(B/C)*	4.96%	3.00%	3.08%
Operating Revenues	*(C)*	70,220	64,496	61,745

SANJO UNIVERSITY OPERATING RATIOS

TABLE B-4

EXPENDABLE NET ASSETS RATIOS

Measures unrestricted resources available against one year's operating costs plus the principal portion of the debt service.

		1996	1995	1994
a. UNRESTRICTED NET ASSETS LESS NET INVESTMENT IN PLANT / TOTAL OPERATING EXPENSES PLUS DEBT SERVICE PRINCIPAL	*(A/B)*	142%	158%	185%
Unrestricted Net Assets		157,212	147,342	143,459
Less: Investment in Plant		(61,047)	(46,491)	(29,796)
		96,165	100,851	113,663
Total Operating Expenses		66,740	62,563	59,841
Debt Service Principal (from Cash Flow Statement or Debt footnote)		1,141	1,068	1,468
	(B)	67,881	63,631	61,309

Measures all resources available for expenditure against one year's operating costs plus the principal portion of the debt service.

b. EXPENDABLE NET ASSETS LESS NET INVESTMENT IN PLANT / TOTAL OPERATING EXPENSES PLUS DEBT SERVICE PRINCIPAL	*(C/B)*	294%	305%	332%
Unrestricted Net Assets		157,212	147,342	143,459
Temporarily Restricted Net Assets		103,537	93,522	89,894
Less: Investment in Plant *(from Appendix A, footnote 7)*		(61,047)	(46,491)	(29,796)
	(C)	199,702	194,373	203,557

SANJO UNIVERSITY OPERATING RATIOS

TABLE B-5

DEBT SERVICE RATIOS

Measures the percentage of debt service to the total operating costs of the institution.

		1996	1995	1994
a. Debt Service to Operating Expenses				
ANNUAL DEBT SERVICE / OPERATING EXPENSES PLUS DEBT SERVICE PRINCIPAL	*(A/B)*	**6.03%**	**5.00%**	**5.75%**
Interest Expense (from Cash Flow Statement or footnotes)		2,952	2,114	2,059
Required Principal Payments on Debt (from Cash Flow Statement or footnotes)		1,141	1,068	1,468
	(A)	4,093	3,182	3,527
Total Operating Expenses		66,740	62,563	59,841
Debt Service Principal (from Cash Flow Statement or Debt footnote)		1,141	1,068	1,468
	(B)	67,881	63,631	61,309

Measures the ability of the institution to meet debt service obligations from normal operating sources.

b. Debt Service Coverage Ratio				
OPERATING SURPLUS PLUS INTEREST EXPENSE / ANNUAL DEBT SERVICE	*(C/A)*	**157%**	**127%**	**112%**
Increase in Unrestricted Net Assets		3,480	1,933	1,904
Interest Expense (from Cash Flow Statement or footnotes)		2,952	2,114	2,059
Operating Surplus Plus Interest Expense	*(C)*	6,432	4,047	3,963

SANJO UNIVERSITY FINANCIAL STRENGTH RATIOS

TABLE B-6

ENDOWMENT RATIO

Measures the total endowment relative to the operating budget/costs of the institution.

			1996	1995
a.	**TOTAL ENDOWMENT (TRUE & QUASI-ENDOWMENT) / TOTAL OPERATING EXPENSES**	*(B/C)*	341%	329%
b.	**TOTAL ENDOWMENT (TRUE & QUASI-ENDOWMENT) WITHOUT PLEDGES / TOTAL OPERATING EXPENSES**	*(A/C)*	326%	313%
	Funds Functioning as Endowment	*(D)*	86,269	85,807
	Accumulated Gains on Restricted Endowment		60,476	43,637
	Endowment & Similar Funds		70,517	66,570
	Endowment & Similar Funds Invested	*(A)*	217,262	196,014
	Pledges Receivable for Endowment		10,147	10,129
	Total Endowment	*(B)*	227,409	206,143
	Total Operating Expenses	*(C)*	66,740	62,563

From Appendix A, footnote 7

TABLE B-7

QUASI-ENDOWMENT RATIO TO TOTAL ENDOWMENT

Measures the portion of endowment that is unrestricted.

		1996	1995
QUASI-ENDOWMENT / TOTAL ENDOWMENT (TRUE & QUASI-ENDOWMENT)	*(D/B)*	37.94%	41.62%

TABLE B-8

ENDOWMENT PER FTE STUDENT

Measures the size of the endowment relative to enrollment.

		1996	1995
TOTAL ENDOWMENT (TRUE & QUASI-ENDOWMENT) / NUMBER OF FULL-TIME EQUIVALENT STUDENTS	*(B/FTEs)*	$79,793	$73,623
Number of full-time equivalent students		2,850	2,800

SANJO UNIVERSITY FINANCIAL STRENGTH RATIOS

TABLE B-9(a)

TOTAL DEBT TO EXPENDABLE UNRESTRICTED NET ASSETS

Measures the ability of the institution to meet outstanding debt from unrestricted net assets.

		1996	1995
TOTAL DEBT OUTSTANDING / UNRESTRICTED NET ASSETS LESS NET INVESTMENT IN PLANT	*(A/B)*	50.52%	49.30%
Total debt outstanding	*(A)*	48,579	49,720
Unrestricted net assets		157,212	147,342
Less: Net investment in plant		(61,047)	(46,491)
	(B)	96,165	100,851

TABLE B-9(b)

TOTAL DEBT TO EXPENDABLE NET ASSETS

Measures the ability of the institution to meet outstanding debt from net assets which ultimately may be expended.

		1996	1995
TOTAL DEBT OUTSTANDING / UNRESTRICTED & TEMPORARILY RESTRICTED NET ASSETS LESS NET INVESTMENT IN PLANT	*(A/B)*	24.33%	25.58%
Total debt outstanding	*(A)*	48,579	49,720
Temporarily restricted net assets		103,537	93,522
Unrestricted net assets		157,212	147,342
Less: Net investment in plant		(61,047)	(46,491)
	(B)	199,702	194,372

TABLE B-10

INCREASE IN NET ASSETS

Measures the growth in the equity of the institution. Should be compared to an objective measure of inflation to determine if there is real equity growth.

		1996	1995
TOTAL INCREASE IN NET ASSETS / TOTAL NET ASSETS BEGINNING BALANCE	*(A/B)*	7.51%	7.63%
Total increase in net assets	*(A)*	23,850	22,510
Net assets at the beginning of the year	*(B)*	317,563	295,052

SANJO UNIVERSITY FINANCIAL STRENGTH RATIOS

TABLE B-11

TOTAL RETURN LONG-TERM INVESTMENTS

Measures the investment performance for the period. Must be measured against the spending policy of the institution as well as a measure of inflation to determine if the investments are really achieving equity growth.

		1996	1995
INVESTMENT INCOME PLUS REALIZED & UNREALIZED GAINS / AVERAGE LONG-TERM INVESTMENTS FOR THE PERIOD	*(B/A)*	10.16%	5.41%
Long-term investments at the beginning of the year		240,743	236,100
Long-term investments at the end of the year		249,152	240,743
		489,895	476,843
Simple average of long-term investments	*(A)*	244,948	238,422
Realized and unrealized gains on investments		15,845	2,756
Investment income		9,053	10,152
	(B)	24,898	12,908

From Appendix A, footnote 4

SANJO UNIVERSITY LIQUIDITY AND CASH FLOW RATIOS

TABLE B-12

WORKING CAPITAL RATIO

Measures institution's ability to meet working capital requirements in due course.

		1996	1995
CURRENT ASSETS / CURRENT LIABILITIES	*(A/B)*	**329%**	**290%**

Current assets include all unrestricted amounts expected to be converted to cash in the next 12 months (e.g. cash, cash equivalents, short-term investments, accounts receivable).
Current liabilities include all amounts payable or accrued which are expected to be paid during the next 12 months (e.g., it would exclude long-term accruals such as for post-retirement benefits).

Current Assets:			
Cash and cash equivalents		14,866	15,650
Accounts receivable, net		1,010	851
Short-term investments		11,993	11,327
Inventories		1,109	1,062
	(A)	28,978	28,890
Current Liabilities:			
Accounts payable and accrued expenses		5,903	7,188
Deposits and deferred revenues		2,897	2,759
	(B)	8,800	9,947

TABLE B-13

OPERATING CASH FLOW TO DEBT SERVICE

Measures ability of institution to meet debt service from operating cash flow.

		1996	1995
NET CASH PROVIDED BY OPERATING ACTIVITIES PLUS INTEREST EXPENSE / DEBT SERVICE (PRINCIPAL & INTEREST)	*(A/B)*	**266%**	**310%**
Net cash provided by operating activities (from Cash Flow Statement)		6,749	7,312
Investment gains used for operations		1,191	433
Interest expense (from Cash Flow Statement or footnotes)		2,952	2,114
	(A)	10,892	9,859
Interest expense (from Cash Flow Statement or footnotes)		2,952	2,114
Required principal payments on debt (from Cash Flow Statement or footnotes)		1,141	1,068
	(B)	4,093	3,182

SANJO UNIVERSITY LIQUIDITY & CASH FLOW RATIOS

TABLE B-14

DEFERRED MAINTENANCE FUNDING CAPABILITY

a. Measures the ability of the institution to fund historical cost depreciation as a surrogate for a deferred maintenance provision. At best an imperfect measure.

NET CASH PROVIDED BY OPERATING ACTIVITIES LESS DEBT SERVICE PRINCIPAL / DEPRECIATION EXPENSE		**1996**	**1995**
	(A/B)	**148%**	**200%**
Net cash provided by operating activities		6,749	7,312
Investment gains used for operations		1,191	433
Less: Debt service principal (payments from Cash Flow Statement)		(1,141)	(1,068)
	(A)	6,799	6,677
Depreciation expense (from the Cash Flow Statement or footnotes)	*(B)*	4,601	3,342

b. Attempts to provide a better measure of the cash requirement to fund deferred maintenance.

NET CASH PROVIDED BY OPERATING ACTIVITIES LESS DEBT SERVICE PRINCIPAL / REPLACEMENT COST DEPRECIATION EXPENSE		
	(A/C)	**61%**

Replacement cost depreciation is not typically available in the basic financial statements. However, many institutions use some method of estimating the expected cost of deferred maintenance. One imperfect method is to determine depreciation using estimated replacement cost which should be available from insurance records, assuming normal coverage for property damage.

	($ in thousands) Historical Cost	**Replacement Cost**	**Asset Life**	**Estimated Replacement Depreciation**
Land and improvements	3,816	0		
Equipment and books	35,597	35,597	7	5,085
Construction in progress	16,634	16,634	35	475
Total other than buildings		52,231		
Insurance replacement cost estimate		245,000		
Estimate of buildings replacement cost	100,166	192,769	35	5,508
Total cost per financial statement footnotes	156,213			
Estimate of Replacement Cost Depreciation			*(C)*	11,068

SANJO UNIVERSITY LIQUIDITY AND CASH FLOW RATIOS

TABLE B-15

PLEDGES RECEIVABLE RATIO

Measures the portion of net assets which is made up of the net present value of recorded pledges.

		1996	1995
PLEDGES RECEIVABLE / TOTAL NET ASSETS	*(A/B)*	**4.49%**	**4.81%**
Pledges receivable	*(A)*	15,333	15,285
Total net assets at end of the year	*(B)*	341,413	317,563

APPENDIX C

SUGGESTIONS FOR FURTHER READING

Strategic indicators for colleges and universities also are discussed in the following publications:

Accounting and Reporting Scholarship Allowances to Tuition and Other Fee Revenues by Higher Education, Position Paper, NACUBO Accounting Principles Committee. Washington, D.C., November 1996.

Augustine, John M. and Robert M. Turner, "College and University Financial Statements Under SFAS Nos. 116 and 117," *The Journal of Financial Statement Analysis*, Summer 1996.

Collins, J. Stephen and Robert M. Turner, "Financial Aid: The Challenge of Affordability and Accessibility," *Reinventing the University: Managing and Financing Institutions of Higher Education 1996*. New York: John Wiley & Sons, Inc., 1996.

Frances, Carol, George Huxel, Joel Meyerson, and Dabney Park, *Strategic Decision Making: Key Questions and Indicators for Trustees*. Washington, D.C.: Association of Governing Boards of Universities and Colleges, 1987.

Perspective on Higher Education, Moody's Investors Services, New York, August 16, 1996.

Ratio Analysis in Higher Education: Measuring Past Performance to Chart Future Direction (Independent Institutions), KPMG Peat Marwick LLP and Prager, McCarthy & Sealy, 1995.

Taylor, Barbara E. and William F. Massy, *Strategic Indicators for Higher Education*. Princeton, N.J.: Peterson's Inc. 1996.

Turner, Robert M. and Kenneth D. Williams, "Greater Accountability in Financial Reporting," *Reinventing the University: Managing and Financing Institutions of Higher Education*. New York: John Wiley & Sons, Inc., 1995.

Viewpoint on Higher Education, Standard & Poor's, New York, Summer 1996.

Three other guides may be helpful. The first suggests procedures and reports governing boards may want to review and traces the flow of financial resources through the programs of the institution. The second highlights the various responsibilities of governing boards and suggests how boards might work most effectively. The third provides examples of management reports for colleges and universities.

Financial Responsibilities of Governing Boards, Association of Governing Boards of Universities and Colleges, Washington, D.C., 1989. (Limited copies of this edition are available; a complete revision of this work is due to be published in 1997.)

Ingram, Richard T. and Associates, *Governing Independent Colleges and Universities: A Handbook for Trustees, Chief Executives, and Other Campus Leaders*. San Francisco: Association of Governing Boards of Universities and Colleges and Jossey-Bass Publishers, 1993.

Presentation and Analysis of Financial Management Information, National Association of College and University Business Officers, Washington, D.C., 1989.

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Jack has consulted with education institutions ranging from large state university systems and well-endowed private colleges to small independent schools. He meets frequently with the boards of many colleges and universities to discuss financial statements and related matters. He also has served on the boards of several nonprofit organizations.

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Bob has published numerous articles on financial reporting, primarily in the area of reporting by nonprofit organizations. He cowrote a recent article with John Augustine, "College and University Financial Statements Under SFAS Nos. 116 and 117," in *The Journal of Financial Statement Analysis.* He also wrote *Financial Reporting and Contributions: A Decision-Making Guide to FASB Nos. 116 and 117,* a monograph for Coopers & Lybrand, and was a contributing author of two chapters in a recent book, *Reinventing the University: Managing and Financing Institutions of Higher Education.* He has conducted several workshops on financial reporting for AGB.

Bob was named outstanding educator of the year for 1995 by the Massachusetts Society of CPAs and received the Ignatian Medal for Service to the College by his alma mater, LeMoyne College. He is a member of the American Accounting Association and the Massachusetts Society of CPAs. Bob holds a Ph.D. from Boston University, an MBA from Boston College, an M.S. from Syracuse University, and a B.S. from LeMoyne College.

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